USING YOUR ESTATE PLANNING TOOLBOX TO FIX YOUR CLIENT'S INCOME TAX PROBLEMS©

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The information herein is provided solely to educate on a variety of topics, including wealth planning, tax considerations, estate, gift and philanthropic planning.

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USING YOUR ESTATE PLANNING TOOLBOX TO FIX YOUR CLIENT'S INCOME TAX PROBLEMS©

I. THE PRIMARY IMPORTANCE OF GOALS-BASED PLANNING FOR THE SUCCESSFUL SUCCESSION OF THE FAMILY WEALTH IRRESPECTIVE OF THE STATUS OF THE TAX LAW.

A. The Importance of First Determining a Client's Goals That Determine the Estate Plan's Essential Strategies.

1. The prevalence of tax driven wealth preservation focus and four suggested rules to change the priority of that focus.

In assisting a client with achieving their goals the state of the tax law and how that affects the plan should not be the "tail that wags the dog." Certain tax-planning advisors assume that a combination of wealth preservation and tax reduction is the purpose of every estate and succession plan. All tax advisors from time to time have been guilty of that assumption.[1] Whenever owners and tax advisors gather to formulate a plan, inevitably their conversations focus extensively on tax issues. Something about the topic of tax planning, the prevalence of tax advisory literature, tax advisors' professional degrees and titles, how the meetings originate, and the expectations of the gathered parties combine to dictate this focus.[2]

Tax planner's habitual patterns of engaging in planning conversations that evolve into tax reduction conversations have resulted in the evolution of a conventional style of planning that can be referred to as *tax driven wealth preservation planning*. This planning style begins with advisors gathering relevant facts and recommending optimum legal structures. In most instances, the defining characteristics of the selected strategies and legal structures are their tax reduction and control retention characteristics. A danger in tax driven wealth preservation planning is its subtle power to enable money (and its conservation) to become the defining objective.

Through the years I have developed four personal rules for determining a client's goals and concerns with respect to the family's capital (as defined below): (1) try to ask open ended questions that give the client the opportunity to articulate his or her goals and concerns; (2) listen; (3) listen, and (4) listen.

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[1] I would like to thank Mike Allen of Allen ◊ Lottmann, P.C., in Tyler, Texas. Around 25 years ago Mike articulated these concepts to me. I have been a better advisor since.

[2] L. Paul Hood, Jr., "*From the School of Hard Knocks: Thoughts on the Initial Estate Planning Interview*," 27 ACTEC Law Journal 297 (2002).

2. Estate plans developed around the stewardship purpose of the family wealth.

It is enlightening to contrast conventional *tax driven wealth preservation plans* with plans which have been formulated for clients who were initially asked (perhaps through the vehicle of many open-ended questions): "What is the purpose (or stewardship mission) of your family wealth?" A family's wealth, or capital, is more than its financial capital. A family's social capital and stewardship capital are also very important and interact with the family's financial capital.

When planning conversations begin with open-ended questions to determine the purpose or mission of the family's capital, a different succession plan may emerge, and the priority of tax reduction can be expected to decline in status from the defining principle to an important collateral objective.

At an introductory stage, a dialogue about purpose or stewardship mission questions might evolve like this:

Question 1:	Do you want to save taxes? Answer: Yes.
Question 2:	Do you want to protect your wealth? Answer: Yes.
Question 3:	Do you want to preserve the same level of consumption? Answer: Yes.
Question 4:	Do you want to empower your children (or favorite charitable causes)? Answer: Yes.
Question 5:	Do you want to give your children (or charitable entities you create) options? Answer: Yes.
Question 6:	Do you want to give your children (or charitable entities you create) incentives? Answer: Yes.
Question 7:	Do you want to maintain control of investment decisions with respect to your wealth? Answer: Yes.
Question 8:	Do you want to maintain your flexibility (control) to change your mind about how and whom should have future stewardship of your wealth? Answer: Yes.
Question 9:	Which of these is most important? Typical Answer: (pause) That is the first time we have been asked that question. We'll need to think about it.

Members of my tax planning fraternity routinely start with good questions. But we sometimes tend to stop asking them too quickly (often after question 3), and we seldom ask question 9.

Questions of stewardship mission or the purpose of the family wealth are not raised lightly. They are the most important questions in the succession planning process. Their answers should govern every design decision.

3. Organizational pattern of a purpose-based estate plan:

A hierarchical organizational pattern for a purpose-based estate plan is:

Purpose

The declared principles for the family's capital which determine the plan's essential characteristics

(having priority over)

Strategies

The alternative game plans for implementing the essential characteristics

(having priority over)

Legal Structures

The legal documents which embody and implement the essential characteristics

4. Compatibility of strategies and legal structures with the stated purpose of family wealth.

When an estate succession plan is organized around declared principles, the strategies and legal structures used to accomplish conventional tax planning are retained, but they are modified as necessary to make them compatible with the declared principles.

B. Once the Purpose and Use of the Family's Capital Has Been Determined, Strategies Should Be Developed to Maximize the Investment Risk-Adjusted, After-Tax Wealth That May be Applied to Those Purposes and Uses.

Under current transfer tax laws, almost all of the US population (estimates are over 99.93%) does not have to worry about strategies that reduce transfer taxes.[3] However, according to the Gallup poll on May 24, 2017, 54% of Americans own stocks and presumably would welcome strategies that would lower income taxes on their individual investments and/or trust investments.

There are strategies that reduce both the income taxes on capital and the transfer taxes on capital. Planning for those two taxes does not have to be, and should not be, an "either, or" exercise. The purpose of this paper is to discuss some of the strategies that reduce both taxes.

II. DEVELOPING WEALTH MANAGEMENT STRATEGIES TO ACCOMPLISH A CLIENT'S GOALS IN THE NEW TAX ENVIRONMENT.

A. Income Tax Versus Estate Tax: A New Paradigm? (It May Not Have to Be).[4]

1. Some of the key income tax and basis rules.

a. Certain key basis rules.

(1) Property acquired by purchase.

If property is purchased the basis will be its cost[5], unless the property is purchased by a grantor trust from the grantor. If property is purchased by a grantor trust from the grantor, the basis will be the basis that the grantor had in the assets and will be treated as if the sale had not occurred.[6]

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[3] The Joint Committee on Taxation estimates that in 2018 only 1,800 of the estimated 2.6 million decedents will have to pay estate taxes.

[4] I would like to thank my colleagues at Goldman Sachs who helped with many of the ideas expressed in this paper: Jeff Daly, Cliff Schlesinger, Karey Dye, Melinda Kleehamer, Chi-Yu Liang, Ed Manigault, Andrew Haave, Cathy Bell and Jason Danziger. Many of the ideas generated in this paper also came from the fertile minds of my attorney friends, including: Carlyn McCaffrey, Ellen Harrison, David Handler, Jonathan Blattmachr, Richard Dees, Mickey R. Davis, Melissa J. Willms, Turney Berry, Ronald J. Weiss, Pamela Endreny and Dan T. Hastings. I would particularly like to thank Steve Gorin. Any reader interested in the subject matter of this paper should *see*, Gorin, "Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications." Steve's treatise contains over 740 pages of materials and is available by emailing him at sgorin@thompsoncoburn.com.

[5] *See*, IRC Sec. 1012.

[6] *See*, Revenue Ruling 85-13, 1985-1 C.B. 184.

(2) Property acquired by gift.

(a) The donor's basis is less than the property's fair market value at the time of gift.

The property's basis is equal to the donor's basis plus a portion of gift tax paid (if any) equal to the portion of the property's value consisting of appreciation over the donor's basis.[7]

(b) The donor's basis is greater than the fair market value of the donated property at the time of the gift.

(i) The basis for determining gain will be basis of the donor.[8]

(ii) The basis for determining loss will be the fair market value of the property at the time of gift.[9]

(iii) There is not any gain or loss, if the donee sells the property between the donor's basis and the fair market value of the property on the date of the gift.[10]

(3) Property acquired by a distribution from a trust or estate.

The beneficiary's basis will be the same as the trust or estate's basis adjusted for any gain or loss recognized on the distribution. The trust or estate could elect under IRC Sec. 643(e)(3) to treat the distribution as a sale for its fair market value.[11] Also, if the beneficiary receives the distribution of the property in satisfaction of a pecuniary bequest, the distribution will be treated as a sale.

(4) Property acquired by inheritance.

The basis of property acquired by inheritance will generally be the value used for Federal estate tax purposes. There are exceptions:

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[7] *See*, IRC Secs. 1015(a) and 1015(d)(1)(A) as limited by 1015(d)(6). For gifts made prior to December 31, 1976, a larger adjustment to basis for gift tax paid may apply.

[8] *See*, IRC Secs. 1015(a) and 1015(d)(1)(A) as limited by 1015(d)(6).

[9] *See*, IRC Sec. 1015(a).

[10] *See*, IRC Sec. 1015(a).

[11] *See*, IRC Sec. 643(e).

(i) The proceeds from receivables, which would have been income to the decedent during his lifetime upon its receipt. The future proceeds from these receivables are referred to as "income in receipt of a decedent."

(ii) On the death of a spouse who holds property as joint tenants, or tenants by the entirety with the other spouse, one-half of the property will be taxed in the decedent's estate and its basis will be adjusted to have the same value as determined for estate tax purposes and the remaining half will retain its basis.

(iii) On the death of an individual who jointly owns property with a person who is not a spouse, all of the property is included in that decedent's estate and the basis of the property will be adjusted to have the same value as determined for estate tax purposes (unless the surviving joint owner can show he contributed to the purchase of the property, in which case inclusion in the estate and the resulting basis adjustment are based on the percentage of the consideration paid to acquire the property that was furnished by the decedent).

(iv) Property that is subject to debt on which the decedent is not personally liable. The basis of the property may only be the net value of property (gross value of the property minus the debt), because that is how it will be reported for estate tax purposes.[12]

(v) Any property that a decedent received by gift within one year prior to death if the decedent bequeaths the property back to the donor. The decedent's pre-death basis in such property will carry over to the donor-legatee, as provided by IRC Sec. 1014(e):

> Appreciated property acquired by decedent by gift within 1 year of death.
>
> (1) In general.
>
> In the case of a decedent dying after December 31, 1981, if –
>
> (A) **appreciated property** was **acquired** by the decedent by **gift** during the 1-year period ending on the date of the decedent's death, and

[12] *See* discussion *infra* Section XVI.D.5.

(B) such property is **acquired from the decedent** by (or **passes from** the decedent to) the **donor** of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.

(2) Definitions.

For purposes of paragraph (1) -

(A) Appreciated property

The term "appreciated property"' means any property if the fair market value of such property on the day it was transferred **to the decedent** by gift exceeds its adjusted basis.

(B) Treatment of certain property sold by estate

In the case of any appreciated property described in subparagraph (A) of paragraph (1) **sold** by the **estate** of the decedent or by a **trust** of which the decedent was the grantor, rules similar to the rules of paragraph (1) shall apply **to the extent** the donor of such property (or the spouse of such donor) is **entitled to the proceeds** from such sale. (Emphasis added).

b. Certain key partnership income tax and basis accounting rules.

As noted above, there are limited ways of changing the basis of an asset without having a recognition event for income tax purposes. However, entities treated as partnerships have tax accounting rules that provide sufficient planning flexibility to shift and change the basis of property. Some of the key partnership income tax and basis accounting rules follow:

(1) Generally, a beginning partner's basis in a partnership is equal to the property contributed or cash paid, plus any income recognized on formation of the partnership, plus the partner's share of the liabilities of the partnership.

A partnership's basis can be increased by the following: additional contributions of cash or property to the partnership; increases in the partner's share of liabilities of the partnership; a partner's assumption of individual liabilities of the partnership; or a partner's share of the taxable income or nontaxable income of the partnership.

A partner's basis is decreased to the extent distributions are made to the partner, partnership losses are allocated to the partner or a partner's share of the liabilities decreases.

(2) Under the "unitary basis" tax accounting rules a partner has a "unitary basis" in his or her partnership interest even if the partner has different classes of partnership interests in different transactions.

The basis of a partner is generally allocated to the relative fair market value of different interests when determining such basis allocation is relevant (e.g., sales or redemptions of partnership interests). For example, a partner may have contributed a low basis asset to a partnership and then transferred or sold the low basis partnership interest to a grantor trust that is ignored for income tax purposes. At a later time that same partner could contribute cash for another partnership interest in the partnership. That contribution of cash will result in proportional increases for both the grantor trust partnership interests and the new partnership interests acquired for cash.

(3) Generally, the contribution of low basis property to a partnership does not trigger gain, but it could.

The primary purpose of IRC Sec. 721 is to allow the formation of a partnership without the recognition of a taxable gain, thus encouraging the growth of new businesses. Many taxpayers have utilized the same concept in an effort to facilitate a sale through the diversification of their marketable investments. A simple example would be for two individuals to form a partnership with one individual contributing $100 of appreciated stock and the other individual contributing $100 of cash. If the partnership is economically a 50/50 arrangement between the partners, the effect of the formation is a sale of 50% of one partner's stock position to the other partner and the purchase of 50% of the stock position by the other partner. If transactions like this would be allowed, many taxpayers could escape the imposition of capital gains taxes on marketable security exchanges through structures that incorporated these concepts. Thus, certain tests were included in the Internal Revenue Code and the regulations that address these issues and preclude certain arrangements from achieving their disguised goals.

Subchapter K of the Internal Revenue Code indicates that, in general, no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.[13] However, if the entity is considered an "investment company," then a taxable sale is deemed to occur.[14] The partners in the partnership must determine if a taxable contribution has occurred via the existence of an

[13] *See* IRC Sec. 721(a).

[14] *See* IRC Sec. 721(b).

investment company. In general, an investment company includes an entity that owns stock, bonds, foreign currencies, REITS and other marketable securities.[15]

The Treasury Regulations further detail the definition of an investment company to include entities where the formation results, directly or indirectly, in diversification of the transferors' interests, and more than 80 percent of its value in assets (excluding cash and nonconvertible debt obligations from consideration) that are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts.[16]

(4) Generally, when a donor makes a gratuitous transfer of a partnership interest to a donee no gain or loss is recognized on the transfer. However, a proportionate share of the basis of that transferred interest may not be transferred.

The IRS has ruled that in calculating the outside basis of a transferred partnership interest the basis of the transferred interest equals an amount that bears the same relation to the entire interest as the fair market value of the transferred portion of the interest bears to the fair market value of the entire interest.[17] Thus, if there is more of a valuation discount on the transferred interest than the original interest, the donor will retain the basis on his retained partnership interest that is not allocated on that proportional test.

(5) Certain partnership tax accounting rules must be navigated to make sure a partnership is not being used as a vehicle for a disguised sale.

Another area of potential taxpayer abuse involves the concept of a partnership formed to specifically disguise a sale where the investment company rules do not apply. A simple example would be for two individuals to form a partnership with one individual contributing $100 of a non-marketable asset through the ownership of two entities and the other individual contributing $100 of cash. If the partnership is economically a 50/50 arrangement between the ultimate partners, the effect of the formation is again a sale of 50% of one owner’s asset to the other partner and the purchase of 50% of the asset by the other partner. Because the asset is not marketable, IRC Sec. 721 does not apply and the formation is not considered a taxable event. However, if the partnership acquired the interest of the second partner by delivering the non-marketable asset, the result would be the receipt of the asset by the second partner without the imposition of a tax and the retention of the cash by the original owner of the non-marketable asset through the partnership. In effect, the original owner would have sold the asset for cash yet not recognized any capital gain until the partnership is ultimately liquidated. In an effort to

[15] *See* IRC Sec. 351(e).

[16] Treas. Reg. §1.351-1(c)(1).

[17] Rev. Rul. 84-53, 1984-1 C.B. 159.

preclude such disguised sale planning opportunities IRC Secs. 704(c), 737 and 707 were included in subchapter K.

In essence, IRC Secs. 704(c) and 737 prevent the distribution of an appreciated asset to one partner that was originally contributed by another partner during a seven-year period.[18] Another way to view the section is that if a partnership exists for more than seven years, or five years if established prior to June 9, 1997, then the IRS probably will view the partnership as having a business purpose other than the disguised sale of an asset.

Besides the seven-year rule of IRC Secs. 704(c) and 737, there is the so-called two-year rule under the regulations of IRC Sec. 707.[19] If a partner transfers property to a partnership and receives money or other consideration, the transfers are presumed to be a sale. Due to the specificity of the two-year rule, a properly structured partnership could avoid the application of a disguised sale if the assets remain within the partnership for an appropriate length of time.

(6) Certain partnership income tax accounting rules exist to determine if a tax is imposed on a partner who liquidates his or her partnership interest.

At some point in the future, the partners may wish to realize the economic benefits of their investment through the distribution of partnership assets or the liquidation of their interest in the partnership. IRC Secs. 731 and 732 address the taxation of such transactions.

Generally, gain will not be recognized to a partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution.[20]

Because of the ease of liquidity related to marketable securities, the IRS has increasingly viewed such instruments as cash. Within the context of a partnership, IRC Sec. 731(c) was added to the Internal Revenue Code. In effect, marketable securities, if deemed to be money, can cause taxable gain, if the fair market value of the distributed securities exceeds the withdrawing partner’s tax basis in the partnership.[21] As with many areas of the tax law, there are always exceptions to the rules. If a partnership meets the definition of an investment partnership, then it is excepted from the capital gain issue created by IRC Sec. 731(c).

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[18] *See* IRC Secs. 704(c)(1)(B), 737(a), and 737(b).

[19] *See* Treas. Reg. §1.707-3(c).

[20] *See* IRC Sec. 731(a).

[21] *See* IRC Sec. 731(c).

As noted in the discussion *infra* Section XIV.A.4, the receipt of marketable securities will not be considered cash, if the partnership is an investment partnership. The general rule for qualifying as an investment partnership is the ownership of marketable investments and never engaging in an actual trade or business other than investing.[22]

(7) Certain partnership tax accounting rules exist to determine a partner's basis in non-cash assets he or she receives.

The basis in the asset distributions or distributions in liquidation of a partner's interest is subject to the tax rules outlined in IRC Sec. 732.

Under IRC Sec. 732, if a partner receives an asset distribution from a partnership, the partner receives the asset subject to a carryover of the partnership's cost basis, and if the partner receives an asset distribution in liquidation of his interest, then the partner will attach his partnership interest cost basis to the assets received in liquidation.[23] The regulations highlight an example illustrating the result.[24]

If a withdrawing partner receives property that has a higher basis than the partner's basis in the partnership interest then the basis in that distributed asset is stripped out and is allocated to the remaining assets of the partnership if certain tax elections are made (see *infra* Section XIV.B.2) or if the distribution is of sufficient size it is automatically made.

(8) The IRS will recognize a division of a partnership between the partners as being tax free if it complies with their requirements.

A division of a partnership may be accomplished if a partnership contributes some of its assets and liabilities to a recipient partnership in exchange for an interest in the recipient partnership, followed by a distribution of the recipient partnership interests to the partners.[25] Because the basis of non-cash distributions to a partner is determined by the outside basis of a partner's interest, careful partnership division allows taxpayers to determine what the tax basis of the in-kind property will be upon distribution (rather than determined by an aggregate basis under the unitary basis rule).

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[22] *See* IRC Sec. 731(c)(3)(C)(i).

[23] *See* IRC Secs. 732(a)(1) and 732(b).

[24] *See* Treas. Reg. §1.732-1(b).

[25] *See* Treas. Reg. §1.708-1(d)(3).

(9) If a partner's interest is redeemed for partnership assets the value paid upon full redemption should be based on the fair market value of the partnership assets that are equal to the fair market value of the redeemed partnership interests.[26]

If the capital account redeemed partnership interest is used instead of its fair market value there could be a deemed gift either by the remaining partners to the withdrawing partner or from the withdrawing partner to the remaining partners to the extent the capital account value differs from the fair market value.

(10) If there is a change in the outside basis of a partnership interest, because of a sale or a death of a partner, that could effect the inside basis of the partnership assets.

If timely election is not made by the partnership (or a distribution and election by the distributee partner under IRC Sec. 732(d)), the death of a partner or a sale of a partnership interest, does not affect the inside basis of the assets held by the partnership at the time of the partner's death or sale. *See* IRC Secs. 754 and 743(a). However, under those circumstances, if that partnership interest is later completely liquidated the estate of successor partner takes a basis in the distributed assets equal to the basis in the partnership interest.

(11) Existing anti-abuse tax accounting rules.

Regardless of the form of a transaction, the IRS added regulations under IRC Sec. 701 (Anti-Abuse Rules) in 1995 that address the substance of a partnership and could cause a tax result derived from a partnership transaction to be negated, if the IRS views the structure as a mechanism to reduce the overall tax burden of the participating partners in a manner inconsistent with the intent of Subchapter K.

It is noteworthy that the above general rule under IRC Sec. 701 is not violated even if the partnership and the liquidating partner have as a principal purpose a basis shift that accrues from following the above tax accounting rules. Despite that purpose, the regulations, by using an example, conclude that purpose does not violate the anti-abuse provisions because the structure that is used is not inconsistent with the intent of Subchapter K.[27] In another example under the regulations the partnership and the liquidating partner had as a principal purpose the shift of basis from a non-depreciable asset to the depreciable asset pursuant to a liquidating distribution. Again, despite that purpose, the regulations conclude that technique does not violate the anti-abuse provisions.[28] The IRS regulation writers took the position that the illustrated technique was not inconsistent with the intent of Subchapter K.

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[26] *See* Treas. Reg. §1.704-4(a)(3).

[27] Treas. Reg. §1.701-2(d), Ex. 9.

[28] Treas. Reg. §1.701-2(d), Ex. 10.

2. If lifetime basis enhancing strategies are not used, from a tax perspective, at what assumed growth rate is it better to use a lifetime transfer tax strategy with a low basis asset in comparison to retaining the asset until death?

Consistent with a private investor's stewardship goals, wealth management strategies should be developed. One component, sometimes a key component, in developing a wealth management strategy for the private investor is the development of a tax efficient strategy that implements the investor's stewardship goals. The development of tax efficient strategies may change for certain assets because estate tax rates and capital gains tax rates have become much closer than they have been for more than a decade. For some taxpayers the combined state and federal capital gains taxes and the 3.8% tax under IRC Sec. 1411 (sometimes referred to in this paper as the "health care tax") can exceed the transfer tax (after consideration of the transfer tax exemption), particularly for negative basis property. As noted above, the only nice "tax" factor about death is that the taxpayer receives a step-up in basis with respect to the taxpayer's low or negative basis assets. That step-up in basis will not occur if that asset is not subject to a lifetime basis enhancing strategy and is not subject to estate taxes in the taxpayer's estate because the taxpayer used a gifting and/or selling strategy to remove that asset from estate taxation. Another factor that did not exist in the past is that a taxpayer's unified credit to be applied against transfer taxes increases each year with inflation.

Simplistically, if an asset will be sold immediately after a taxpayer's death if the tax result is the only factor (of course, it is rare that the tax result is the only factor), and if lifetime basis enhancing strategies are not used, the decision to subject a low basis asset to a lifetime transfer strategy to a non-grantor trust, in order to save future estate taxes, or to hold the asset in order to receive a step-up in basis, is determined by a taxpayer's assumption of how fast a low basis asset will increase in value in the future. There is not an exemption protecting the assessment of a capital gains tax on the sale of an asset. There are substantial exemptions protecting the assessment of a transfer tax. The amount of tax that you would pay by gifting the asset now is the gift tax paid now (if any) plus the capital gains tax paid upon a sale at death. The amount of tax that you would pay by bequeathing the low basis asset at death is the estate tax paid at death. There is a growth rate where the taxpayer will pay the same taxes whether the taxpayer gives the asset now, or at the taxpayer's death. If the taxpayer assumes a growth rate will be higher than that breakeven growth rate, then it is more tax efficient to gift the asset now. If the taxpayer assumes a growth rate is lower than that breakeven growth rate, then it is more tax efficient to bequeath the asset at death and receive the stepped-up basis. The assumed growth rate is a function of the taxpayer's assumed life expectancy times the assumed annual growth rate of the asset. A taxpayer's assumption as to the estate tax exemption that will be available at death is based on the taxpayer's assumption as to the growth of the exemption caused by inflation and whether that future exemption growth will be used by the taxpayer's other assets anyway. For instance, if the taxpayer will have other low basis assets that will use the growth of the assumed estate tax exemption, that should be reflected in the taxpayer's analysis of whether to make a

lifetime transfer of the asset or hold it until death. The determination of the breakeven growth rate can be expressed by the following formula:[29]

Breakeven Growth Rate During the Taxpayer's Life Expectancy =

$$\frac{\text{Capital Gain Rate}(\text{Gift Value} - \text{Basis}) + \text{Gift Tax Rate}(\text{Gift Value} - \text{Remaining Gift Tax Exemption}) - \text{Estate Tax Rate}(\text{Gift Value} - \text{Estate Tax Exemption at Death})}{\text{Value of Gift}\,(\text{Estate Tax Rate} - \text{Capital Gains Rate})}$$

Consider the following example:

Example 1: Is it Better for a Private Investor Who Owns a Low Basis Asset That Will Not Be Sold During His Lifetime, But Will Be Sold On His Death, to Give That Asset Away to His Family Now, or Hold That Asset Until His Death?

Danny Lowbasis owns $11,180,000 in shares of a near zero basis stock that he is confident he will not sell during his lifetime, but his family would sell immediately after his death. Danny has $11,180,000 in gift tax exemption remaining. Danny believes he has a 15-year life expectancy. Danny also believes the estate tax exemption will increase to $15,810,000 by the time of his death (because of an assumed inflation rate of 2.5%).

Danny is willing to give his family that amount of the stock that will not generate gift taxes or $11,180,000 of the stock, if it saves future estate taxes greater than the future income taxes and health care taxes that will accrue because of the loss of the step-up in basis at death on the gifted shares. Danny asks his planner, Ima Mathgeek, at what assumed annual rate of appreciation during his lifetime does it make sense to give $11,180,000 of the stock away to his family as opposed to holding the stock and bequeathing the stock to his family.

Under the above formula, if a gift to a non-grantor trust is contemplated, if a taxpayer has a 15-year life expectancy, if after the gift that taxpayer will not have any other assets in which an increased estate tax exemption could be used, and if the taxpayer lives in a state without an income tax (e.g., Texas), the breakeven growth rate over a 15-year period for gifting a zero basis asset is determined under the above formula is as follows:

$$\frac{.238(\$11,180,000) + .40(0) - .40(\$11,180,000 - \$15,810,000)}{\$11,180,000\,(.162)} = \frac{\$2,660,840 + \$1,852,000}{\$1,811,160} = 249.17\%$$

[29] I would like to thank Kelly Hellmuth of McGuire Woods who generously allowed me to publish her formula.

On a compounded annualized basis 249.17%, over a 15-year period, is equal to a per annum growth rate of 8.69%. Please *see* the spreadsheet analysis in Schedule 1. If a taxpayer lives in California, under those assumptions, the compounded annualized breakeven growth rate is 21.9% for gifting a zero basis asset. *See* also the spreadsheet analysis in attached Schedule 2.

However, very few taxpayers can afford to give away all of their assets. If you assume the taxpayer will have enough low basis assets at death to offset the anticipated increase in estate tax exemption, even if a gift is made, this will change the breakeven growth rate. To determine the breakeven growth rate under those circumstances, in order to isolate the breakeven growth rate for a particular asset, it may be necessary to assume the projected estate tax exemption will be equal to the current gift tax exemption. Under the above assumptions, if you assume the taxpayer could use the estate tax exemption that exists at death against other low basis assets, the Texas breakeven annualized compounded growth rate for gifting a zero basis asset is 6.21% and the California breakeven annualized compounded growth rate for gifting a zero basis asset is 19.12%. *See* the analysis in Schedules 3 and 4.

Another problem with the formula is that it does not take into account the after tax power of grantor trusts and basis enhancing strategies. Those strategies will be explored in this paper.

The above analysis would suggest, to a certain extent, from a tax perspective, current planning should be more specific by asset.

3. There may be non-tax factors, such as risk-adjusted investment considerations, which make holding a low basis asset until death for the basis step-up disadvantageous.

As noted above, non-tax factors such as asset protection planning, planning for future stewardship considerations, and planning for later years post retirement may override tax considerations.

Risk adjusted investment considerations may also override the tax considerations. There may be a significant inherent investment risk in not diversifying out of a large single asset that is part of one asset class, into multiple assets held in many different asset classes.

Consider the following table that ranks eleven asset classes by pre-tax returns, and risk or volatility, from the time period 2001-2017, and ranks each asset class by returns for each year from 2007 to 2017.

Table 1

Asset Class Returns – As of December 31, 2017

2001 - 2017		Returns										
Returns (Ann.)	Vol (Std. Dev.)	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Emerging Market Equity 11.0%	REITs 22.4%	Emerging Market Equity 39.8%	Investment Grade Munis 4.2%	Emerging Market Equity 79.0%	MLPs 35.9%	MLPs 13.9%	Emerging Market Equity 18.6%	US Small Cap 38.8%	REITs 32.0%	Non-US Equity (USD Hedged) 5.0%	US Small Cap 21.3%	Emerging Market Equity 37.8%
MLPs 10.2%	Emerging Market Equity 21.7%	MLPs 12.7%	Hedge Funds -21.4%	MLPs 76.4%	REITs 28.1%	REITs 9.4%	High Yield Munis 18.1%	US Large Cap 32.4%	High Yield Munis 13.9%	REITs 4.5%	MLPs 18.3%	Non-US Equity 25.6%
REITs 10.1%	US Small Cap 18.9%	Global Equities 12.2%	High Yield Munis -27.0%	Global Equities 35.4%	US Small Cap 26.9%	High Yield Munis 9.2%	Non-US Equity 17.9%	MLPs 27.6%	US Large Cap 13.7%	Investment Grade Munis 2.4%	US Large Cap 12.0%	Global Equities 24.6%
US Small Cap 8.3%	Non-US Equity 16.7%	Non-US Equity 11.6%	US Small Cap -33.8%	High Yield Munis 32.7%	Emerging Market Equity 19.2%	Investment Grade Munis 7.6%	Non-US Equity (USD Hedged) 17.5%	Non-US Equity (USD Hedged) 26.7%	Non-US Equity (USD Hedged) 5.7%	High Yield Munis 1.8%	Emerging Market Equity 11.6%	US Large Cap 21.8%
US Large Cap 7.0%	MLPs 16.7%	Hedge Funds 10.3%	MLPs -36.9%	Non-US Equity 32.5%	US Large Cap 15.1%	US Large Cap 2.1%	REITs 17.1%	Global Equities 23.4%	US Small Cap 4.9%	US Large Cap 1.4%	Global Equities 8.5%	Non-US Equity (USD Hedged) 16.8%
Global Equities 6.8%	Global Equities 15.3%	US Large Cap 5.5%	US Large Cap -37.0%	REITs 28.5%	Global Equities 13.2%	US Small Cap -4.2%	Global Equities 16.8%	Non-US Equity 23.3%	MLPs 4.8%	Hedge Funds -0.3%	REITs 6.7%	US Small Cap 14.6%
Non-US Equity 6.1%	Non-US Equity (USD Hedged) 14.3%	Non-US Equity (USD Hedged) 5.3%	REITs -39.2%	US Small Cap 27.2%	Non-US Equity 8.2%	Hedge Funds -5.7%	US Small Cap 16.3%	Hedge Funds 9.0%	Investment Grade Munis 4.7%	Non-US Equity -0.4%	Non-US Equity (USD Hedged) 6.1%	High Yield Munis 9.7%
High Yield Munis 5.7%	US Large Cap 14.1%	Investment Grade Munis 4.8%	Non-US Equity (USD Hedged) -39.9%	US Large Cap 26.5%	High Yield Munis 7.8%	Global Equities -6.9%	US Large Cap 16.0%	REITs 1.2%	Global Equities 4.7%	Global Equities -1.8%	High Yield Munis 3.0%	Hedge Funds 7.8%
Non-US Equity (USD Hedged) 4.4%	High Yield Munis 7.0%	US Small Cap -1.6%	Global Equities -41.8%	Non-US Equity (USD Hedged) 25.7%	Hedge Funds 5.7%	Non-US Equity -11.7%	MLPs 4.8%	Investment Grade Munis -0.3%	Hedge Funds 3.4%	US Small Cap -4.4%	Non-US Equity 1.5%	REITs 3.8%
Investment Grade Munis 3.9%	Hedge Funds 4.7%	High Yield Munis -2.3%	Non-US Equity -43.1%	Hedge Funds 11.5%	Non-US Equity (USD Hedged) 5.6%	Non-US Equity (USD Hedged) -12.1%	Hedge Funds 4.8%	Emerging Market Equity -2.3%	Emerging Market Equity -1.8%	Emerging Market Equity -14.6%	Hedge Funds 0.5%	Investment Grade Munis 3.5%
Hedge Funds 3.5%	Investment Grade Munis 3.1%	REITs -17.6%	Emerging Market Equity -53.2%	Investment Grade Munis 7.2%	Investment Grade Munis 3.1%	Emerging Market Equity -18.2%	Investment Grade Munis 3.6%	High Yield Munis -5.5%	Non-US Equity -4.5%	MLPs -32.6%	Investment Grade Munis -0.1%	MLPs -6.5%

Source: Datastream, Bloomberg, JP Morgan Dataquery.

Annualized Volatility and Returns since July 2001 through December 2017. Indices: Investment Grade Municipal Bonds – Barclays Capital Municipal 1-10; Municipal High Yield – Barclays Capital Municipal High Yield; EM Local Debt – JP Morgan EM Local Debt (GBI EM); US Large Cap – S&P 500; US Small Cap Equity – Russell 2000; Non-US Equity – MSCI EAFE; Global Equity – MSCI All Country World; Emerging Market Equity – MSCI Emerging Markets; Hedge Funds – HFRI Fund of Funds Composite; REITs – Dow Jones Wilshire REITs; MLPs – Alerian MLP.

For example, "master limited partnerships" ranked second in pre-tax returns from 2001-2017, ranked the fifth most volatile class from 2001-2017 and ranked last in pre-tax returns in 2017. "Non-US equity" ranked seventh in pre-tax returns from 2001-2017, but were ranked the fourth most volatile class from 2001-2017. Also, as the above table demonstrates, depending upon the investment year, an asset class may significantly differ in its "return" ranking. For instance, "master limited partnerships" was ranked second performing asset class by pre-tax return in 2016 and it ranked last in 2017. Obviously, the volatility of any single asset in an asset class may be considerably greater than the asset class volatility. Hence, depending upon a taxpayer's life expectancy, the non-tax argument for selling a low basis asset to diversify to improve a taxpayer's risk adjusted return, as opposed to holding the asset to achieve a step-up in basis at death, is generally there.

4. The capital gains tax advantage of a step-up at death may be unimportant, if the asset is a legacy asset that will not be sold by the taxpayer's heirs.

Another consideration is whether or not a low basis asset will be sold by a taxpayer's family after the taxpayer's death. If the family views the asset as a "legacy" asset that will never be sold, then income tax considerations are not relevant and transfer tax considerations are paramount. Under those circumstances transfer planning for that asset is more important, even if the above formula indicates transfer planning should not be utilized.

5. Taking all of the above factors into account, when should a lifetime gifting strategy for a low basis asset be considered?

Lifetime gift planning should be considered for a low basis asset for a client who is projected to have a taxable estate unless all of the following factors exist: (i) the above formula (*see supra* Section II.A.2) indicates gift planning should not be utilized, (ii) the taxpayer thinks it will be unlikely he will ever wish to sell that asset because of its investment risk, (iii) non-tax considerations such as asset protection planning, planning for future stewardship and cash flow planning for retirement do not exist; (iv) the taxpayer is convinced that his family will sell that asset immediately after his death; and (v) if it is unlikely a lifetime basis enhancing strategy will be used. Those assets and situations do exist, but it is respectfully submitted that those assets and situations are rare (e.g., negative basis real estate that is well positioned to keep its value and the taxpayer's family will sell it immediately after his death.)

While it may be rare that transfer planning for a wealthy client's low basis assets should not be considered, it is rarer still that a client would also not wish to consider lifetime income tax planning and basis enhancing strategies that are consistent with transfer tax saving strategies.

B. Why Wealth Management Strategies, Including Investment Management Strategies, Are Entirely Different for the Private Wealth Investor in Comparison to the Institutional Investor and Why Tax Management Strategies Are an Important Consideration for the Private Wealth Investor.

1. Congress gives the private investor significant after tax subsidies for his equity investments in comparison to his fixed income investments.

A key income tax factor that affects wealth management strategy of a private investor's portfolio, in comparison to construction of an institutional investor's portfolio, is the significant degree Congress subsidizes an equity investment (which may have a low basis in comparison to value) in comparison to a fixed income investment (which generally has a high basis in comparison to value):

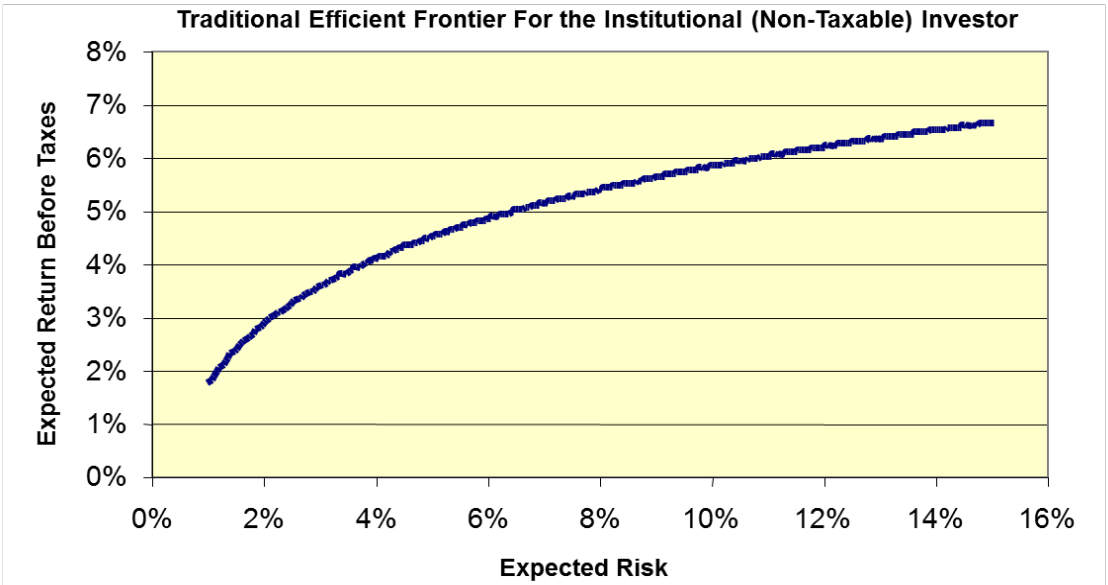
(i) substantially lower rates of taxation;

(ii) the private investor, under the tax laws, may choose when he realizes taxable income on any equity investment (turnover rate), but cannot when he owns a taxable bond investment; and

(iii) the private investor may determine how much of an equity investment's unrealized income is ever taxed (e.g., the private investor could bequeath the equity investment to a charity).

2. What is the efficient investment frontier for the private investor? (hint: it is probably not what you learned in finance class.)

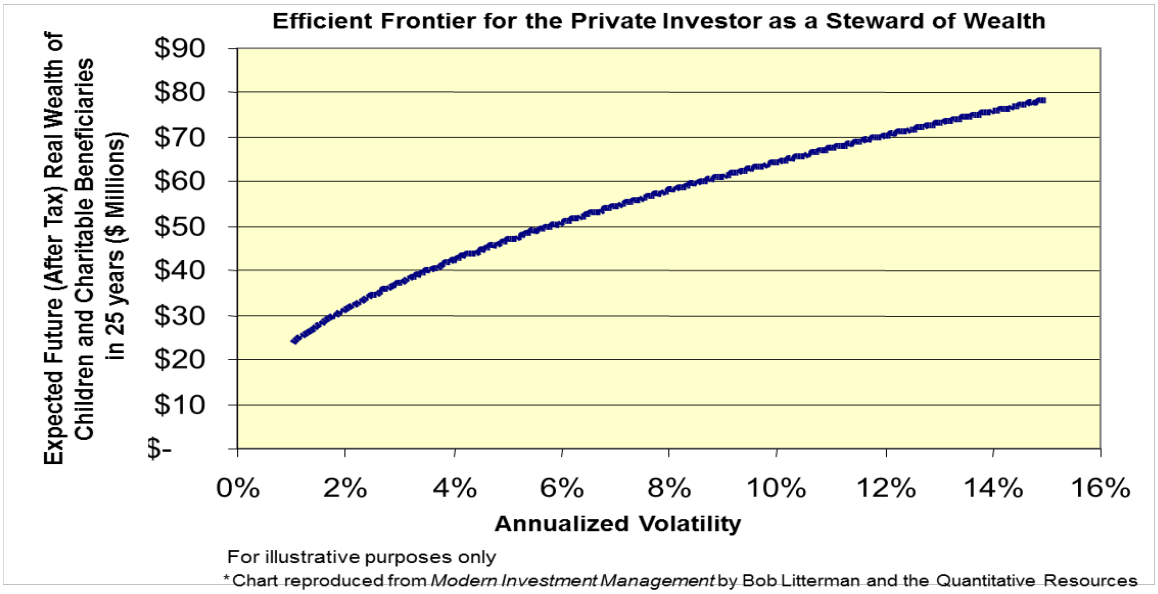
The traditional efficient frontier, illustrated below, will not work for the private investor, who pays taxes, like it does for the institutional investor that does not pay taxes. This is because gross return does not equal wealth for the taxable private investor due to income taxes, health care taxes and transfer taxes.



For illustrative purposes only

*Chart reproduced from *Modern Investment Management* by Bob Litterman and the Quantitative Resources Group of Goldman Sachs Asset Management (2003)

Instead, the efficient frontier of the private investor, who views himself as a steward of wealth, is a comparison of the expected future after-tax real wealth the investor's beneficiaries will receive in comparison to expected after-tax real wealth risk of the wealth management strategies, as illustrated below.

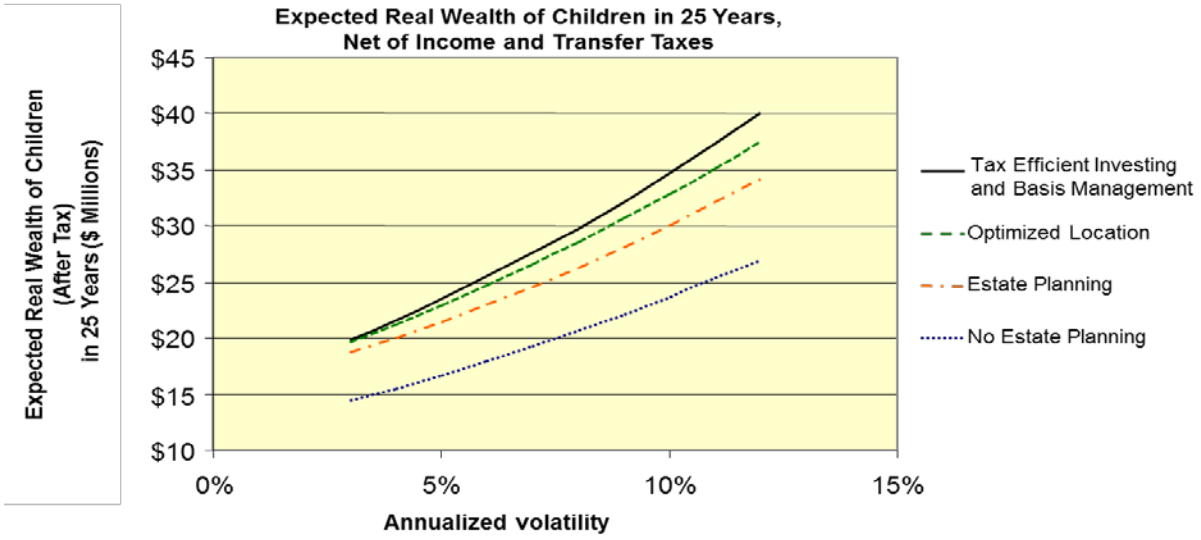


For illustrative purposes only

*Chart reproduced from *Modern Investment Management* by Bob Litterman and the Quantitative Resources Group of Goldman Sachs Asset Management (2003)

3. What are the key components of structuring a wealth management strategy for a private investor?

A wealth management strategy for a private investor involves much more than constructing an investment strategy. A wealth management strategy involves estate and income tax planning that is consistent with the private investor's stewardship goals, optimized location of asset classes in the tax-advantaged entities the private investor has created, and the use of income tax efficient investing and basis enhancing strategies when possible. A sample efficient frontier for the private investor, as a steward of wealth, is illustrated below.



For illustrative purposes only

*Chart reproduced from *Modern Investment Management* by Bob Litterman and the Quantitative Resources Group of Goldman Sachs Asset Management (2003)

Tax efficient investing and basis management uses the mathematical power of tax-free compounding deferral. Consider the table below (also see Schedule 5 attached):

Table 2

	Taxes Delayed Until Year 30 (1)	Taxes Paid Annually (2)	% Increase in Annual Rate of Return to Breakeven Compared to Delayed Tax (2-1)/1
4% Annual Return			
Ordinary Income Tax - Current Tax Rate of 40.8%	4.00%	4.83%	20.65%
LTCG Tax - Current Tax Rate of 23.8%	4.00%	4.43%	10.84%
8% Annual Return			
Ordinary Income Tax - Current Tax Rate of 40.8%	8.00%	10.75%	34.37%
LTCG Tax - Current Tax Rate of 23.8%	8.00%	9.36%	17.04%
12% Annual Return			
Ordinary Income Tax - Current Tax Rate of 40.8%	12.00%	17.13%	42.78%
LTCG Tax - Current Tax Rate of 23.8%	12.00%	14.47%	20.61%

Since the 1933 and 1934 Securities Acts were passed, the S&P 500 (or what the S&P 500 would have been before the measure was invented) for the period 1935-2016, taking dividends into account, has grown at a compounded mean annual rate of 12.5% and a compounded median annual rate of 14.7%. **As the table above demonstrates, if a taxpayer can defer taxation for 30 years, and if the mean annual rate of his investments is 12%, that taxpayer would have to increase his annual rate of return by 42.78% to achieve the same result, if that non-deferred rate of return is subject to ordinary income tax rates (40.8%) under current law. If a taxpayer can defer taxation 30 years, and if the mean annual rate of his investments is 12%, that taxpayer would have to increase his annual rate of return by 20.61% to achieve the same result, if that non-deferred rate of return is subject to capital gains income tax rates (23.8%) under current law.**

C. The Purposes of This Paper: Explore Wealth Management Strategies That Utilize a Combination of Effective Estate Planning Strategies, Optimized Location of Asset Classes in Family Entities and Basis Enhancing Strategies to Decrease Both Income Taxes and Transfer Taxes on a Net Basis.

The question this paper will address is: are there transfer tax management strategies for low basis assets (perhaps in conjunction with basis enhancing strategies and asset location strategies), that do not sacrifice income tax and health care tax considerations? If so, what are some of the best strategies we see? There are many strategies that focus only on income tax and the health care tax. The purpose of this paper is to generally focus on strategies that also address the transfer tax.

A perfect income tax and transfer tax strategy, or combination of strategies, would accomplish all of the following:

1. **The strategy would be consistent with the taxpayer's nontax investment goals and stewardship goals.**
2. **The strategy would eliminate a taxpayer's current transfer taxes and/or transfer taxes that may be imposed by a future Congress.**
3. **The strategy would either enhance the basis of the taxpayer's low basis assets to equal their fair market value, or eliminate any capital gains if the assets are sold.**

This paper will focus on planning strategies or a combination of strategies that accomplish the above goals, including: various borrowing, location, disregarded entity, sale to a grantor trust, contribution of a leveraged disregarded entity either to a grantor trust or a grantor retained annuity trust, qualified Subchapter S trust, mixing bowl and charitable planning strategies. The paper will also explore various strategies that reduce an estate tax protected complex trust's income taxes.

III. USE OF INTENTIONALLY DEFECTIVE GRANTOR TRUSTS AND SALES TO INTENTIONALLY DEFECTIVE GRANTOR TRUSTS ("SIDGT" TECHNIQUE).

A. The Technique.

A taxpayer could contribute a low basis asset to an intentionally defective grantor trust that does not pay income taxes or health care taxes. The taxpayer will pay the income taxes and health care taxes associated with any taxable income earned by the trust. If the grantor trust sells a low basis asset, the taxpayer will pay less estate tax, because his estate is liable for the income taxes and health care taxes associated with that sale. A trust that does not pay income taxes and health care taxes will grow much faster than a trust that does pay income taxes and health care taxes. Any growth by the grantor trust's assets will escape future estate taxes. This technique is a very powerful transfer tax savings technique. Stated differently, depending on one's tax perspective, when a taxpayer uses intentionally defective grantor trusts, that taxpayer is using income taxes and health care taxes to subsidize the payment of transfer taxes or vice versa.

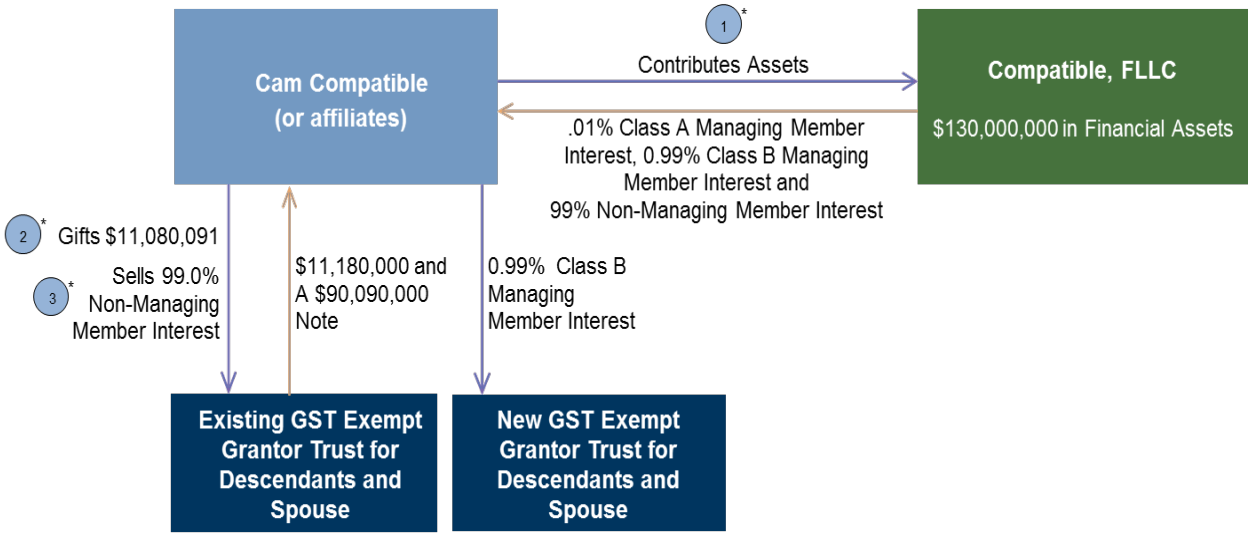
Consider the following example:

Example 2: Cam Compatible Creates an Intentionally Defective Grantor Trust for the Benefit of His Spouse and Family and Makes Certain Sales to That Trust ("SIDGT") Technique

Cam Compatible owns $150,000,000 in financial assets. Cam and affiliates contribute $130,000,000 to a family limited liability company ("FLLC") (Transaction 1). In a separate and distinct transaction (Transaction 2) Cam contributes $11,180,091 to a trust that is a grantor trust for income tax purposes. The trust treats his wife, Carolyn, as the discretionary beneficiary and gives her certain powers of appointment over the trust. Cam, at a much later time (Transaction 3), sells non-managing member interests to that trust, pursuant to a defined value allocation formula, in consideration for cash and notes.

Due to considerations with respect to retaining entity distribution, amendment and liquidation powers, Cam could retain the 0.01% Class A managing member interest and transfer the 0.99% Class B managing member interest. The Class A managing member interests would control all entity managing member decisions, including investment management decisions that are not delegated to the Class B managing member interest. The Class B managing member interests would control all distribution, amendment and liquidation decisions.

Cam could give his Class B managing member interest to a grantor trust in which the initial trustee is an advisor or family member he trusts. Cam could have the power to replace the trustee of that donee trust with a new trustee, as long as the replacement trustee is not related or subservient. Assuming a 33.3% valuation discount, the technique is illustrated below:



* These transactions need to be separate, distinct and independent.

If the considerations noted below can be addressed, this technique would provide significant flexibility to both Cam and Carolyn in making sure their consumption needs are met in the future and, depending upon the terms of the powers of appointment that Cam gives Carolyn, could provide the flexibility that they need to address any changing stewardship goals that may accrue.

B. Income Tax and Basis Enhancing Advantages of the Technique.

1. The ability to create an income tax disregarded trust.

IRC Secs. 671 through 677 contain rules under which the grantor of a trust will be treated as the owner of all or any portion of that trust, referred to as a "grantor trust." If a grantor retains certain powers over a trust, it will cause the trust to be treated as a grantor trust. If the grantor is treated as the owner of any portion of a trust, IRC Sec. 671 provides that those items of income, deductions, and credits against the tax of the trust that are attributable to that portion of the trust are to be included in computing the taxable income and credits of the grantor to the extent that such items will be taken into account in computing the taxable income or credits of an individual. An item of income, deduction or credit included under IRC Sec. 671 in computing the taxable income and credits of the grantor is treated as if received or paid directly to the grantor.[30] Thus, if the private investor contributes assets to an intentionally defective grantor trust, the assets will grow (from the point of view of the trust beneficiaries) income-tax free. Furthermore, the IRS now agrees that there is no additional gift tax liability, if the private investor continues to be subject to income taxes on the trust assets and there is no right of reimbursement from the trust.[31]

Under Rev. Rul. 85-13,[32] a grantor is treated as the owner of trust assets for federal income tax purposes to the extent the grantor is treated as the owner of any portion of the trust under IRC Sec. 671-77. In that ruling, even though activities with a grantor trust are not specifically disregarded by statute or the regulations under the statutes, it was held that a transfer of trust assets to the grantor in exchange for the grantor's unsecured promissory note is not recognized as a sale for federal income tax purposes.[33] The ruling held that the taxpayer cannot have income tax recognized activities with an entity (i.e., a grantor trust) that does not exist for income tax purposes.

Similarly, if the grantor is treated as the owner of the trust property and transfers property into the trust in exchange for property previously held by the trust, such transfer will not be recognized as a sale, exchange or disposition for federal income tax purposes.[34] Thus, no gain or loss is realized by the grantor or the trust. The basis of the property transferred into the trust is unaffected by the transfer, and neither the grantor or the trust acquires a cost basis in the assets transferred from or to the trust.

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[30] Treas. Reg. Section 1.671-2(c).

[31] *See* Rev. Rul. 2004-64, 2004-2 C.B. 7.

[32] Rev. Rul. 85-13, 1985-1 C.B. 184.

[33] *See also*, PLR 9146025 (Aug. 14, 1991) (finding that transfer of stock to grantor by trustees of grantor trust in satisfaction of payments due grantor under the terms of the trust does not constitute a sale or exchange of the stock).

[34] *See* PLR 9010065 (Dec. 13, 1989).

It is possible to design a grantor trust that is defective for income tax purposes (e.g., a retained power to substitute assets of the trust for assets of equivalent value), but is not defective for transfer tax purposes. In comparison to discounting or freezing a client's net worth, over periods of 20 years or more, the effect of paying the income taxes of a grantor trust is generally the most effective wealth transfer technique.

2. The advantage of locating income tax inefficient asset classes inside a grantor trust that is not subject to estate taxes.

a. The technique of asset class location in order to improve the after-tax, after-risk adjusted rate of return for an investment portfolio.

In order to optimize after-tax risk-adjusted returns, wealth management for the private taxable investor involves: (i) the creation of tax advantaged entities; (ii) the investment in asset classes that produce an optimal after-tax risk-adjusted return; and (iii) asset class location in different tax advantaged entities.

Certain asset classes that may optimize risk-adjusted returns may not be income tax efficient, which could produce a less than optimal after-tax risk adjusted return for the private investor, unless the technique of locating those asset classes in estate tax protected grantor trusts is used.

Stated differently, not every asset class that an investor and the investor's family would desire in their collective investment portfolios in order to reduce the portfolio's risk, or volatility, lends itself to investment via a tax efficient low turnover fund (i.e., a broad based passive equity fund). For instance, asset classes such as high yield bonds, hedge funds, master limited partnerships, emerging market debt and various forms of private equity are not available in a passive, low turnover (tax efficient) product. An investor and his family may have all of those asset classes in their collective portfolios. *See* Table 1 *supra* Section II.A.3.

b. Location of Tax Inefficient Investment Classes in a Grantor Trust Significantly Ameliorates the Income Tax Inefficiencies of Those Classes, Because Transfer Taxes Are Saved When the Grantor Pays the Income Taxes of the Trust.

Engaging in an asset class location strategy of locating income tax inefficient asset classes in grantor trusts, and other family planning vehicles, may greatly ameliorate those tax inefficiencies and lead to an optimal after tax risk adjusted return for the private investor. There exist various techniques for the investor to have direct, or indirect, access to these tax efficient entities. There exist various techniques for the investor to create these tax efficient entities without paying gift taxes.

Table 3 below illustrates the annual growth required for an equity fund to double (after both income taxes and transfer taxes) for an investor's beneficiaries, if the investor dies in 10 years, depending upon how a fund is located (also *see* attached Schedule 6). This table also

illustrates the significant wealth management advantages for the private investor who: (i) engages in estate planning; (ii) invests income tax efficiently for those asset classes that he can; and (iii) optimizes location of tax inefficient asset classes in estate tax protected grantor trusts to ameliorate income tax inefficiencies.

Table 3

Equity Fund's Annual Turnover of Assets	Annual Growth Rate Required on a $1mm Equity Fund Which Has a 2% Dividend Rate to Achieve $2mm (After Tax) for Investor's Beneficiaries for an Investor Who Dies in 10 Years[1], Depending Upon How a Fund Is Located, and Percentage Improvement to Equal Equity Fund with 5% Turnover[2], 20% Turnover[3] or 50% Turnover[4]																							
	No Estate Planning Fund Owned by Investor								Estate Planning Techniques Fund is Not Subject to Estate Taxes but Grantor's Estate is Subject to Estate Taxes												Fund Owned by Charity			
	Fund is Owned by Investor and Investor's Estate is Not Subject to Estate Tax Because of Existing Exemptions and/or Charitable Bequests				Fund is Owned by Investor and is Fully Taxable in the Investor's Estate				Fund is in a Grantor Trust and Grantor Buys the Assets from the Grantor Trust for Cash Shortly Before Grantor's Death				Fund is in a Grantor Trust at Investor's Death and Remaining Unrealized Income is Taxed in 10 Years Before Grantor's Death				Fund is in a Grantor Trust at Investor's Death and Remaining Unrealized Income is Taxed in 10 Years After Grantor's Death				Fund is Held in a Non-Grantor Trust and Remaining Unrealized Income is Taxed in 10 Years				Fund is Not Subject to Income Taxes or Estate Taxes Because Fund is Owned by a Charity			
	A				B				C				D				E				F				G			
		(2)	(3)	(4)		(2)	(3)	(4)		(2)	(3)	(4)		(2)	(3)	(4)		(2)	(3)	(4)		(2)	(3)	(4)		(2)	(3)	(4)
Indexed Fund with 5% Annual Turnover[5]	5.94%	N/A	N/A	N/A	11.78%	N/A	N/A	N/A	5.63%	N/A	N/A	N/A	6.16%	N/A	N/A	N/A	6.58%	N/A	N/A	N/A	6.97%	N/A	N/A	N/A	5.18%	N/A	N/A	N/A
Active Beta Indexed Fund with 20% Annual Turnover[6]	6.64%	11.72%	N/A	N/A	13.06%	10.87%	N/A	N/A	6.00%	6.57%	N/A	N/A	6.31%	2.51%	N/A	N/A	6.51%	1.08%	N/A	N/A	7.29%	4.64%	N/A	N/A	5.18%	0.00%	N/A	N/A
Equity Fund with 50% Annual Turnover[7]	7.50%	26.27%	13.02%	N/A	14.80%	25.60%	13.28%	N/A	6.41%	13.94%	6.91%	N/A	6.53%	6.05%	3.46%	N/A	6.58%	0.09%	1.18%	N/A	7.77%	11.55%	6.61%	N/A	5.18%	0.00%	0.00%	N/A
Equity Fund with 100% Annual Turnover[8]	9.55%	60.75%	43.89%	27.31%	19.04%	61.62%	45.76%	28.67%	7.23%	28.58%	20.64%	12.85%	7.23%	17.47%	14.59%	10.76%	7.23%	10.00%	11.20%	9.89%	9.55%	37.08%	31.01%	22.89%	5.18%	0.00%	0.00%	0.00%

(1) These calculations ignore the effect of investment management fees, state income taxes and investment friction costs. These calculations assume the estate planning vehicles are created without paying gift taxes. An equity fund owned by a tax exempt entity would need 5.18% annual growth rate of return over 10 years, assuming a 2% dividend rate, to achieve $2mm.
(2) % annual improvement necessary to equal fund with 5% annual turnover.
(3) % annual improvement necessary to equal fund with 20% annual turnover.
(4) % annual improvement necessary to equal fund with 50% annual turnover.
(5) 100% short-term realized gains in year 1, 0% short-term realized gains and 100% long-term realized gains in years 2-10.
(6) 100% short-term realized gains in year 1, 10% short-term realized gains and 90% long-term realized gains in years 2-10.
(7) 100% short-term realized gains in year 1, 25% short-term realized gains and 75% long-term realized gains in years 2-10.
(8) 100% short-term realized gains in years 1-10.

The asset location of a tax inefficient investment is particularly important. There is a much more modest differential on what is needed to earn pre-tax for a tax inefficient investment, in comparison to a tax efficient investment, in order to double the investment over a 10-year period, if the investment is located in an estate tax protected grantor trust, as opposed to being taxed in the taxpayer's estate. For instance, if a fund is located in an estate tax protected grantor trust, and if the remaining unrealized income is taxed after the grantor's death, a 100% turnover fund (e.g., certain hedge funds) needs to earn 7.23% before taxes to double the value of the investment after taxes in 10 years and a 5% turnover fund (e.g., S&P 500 index fund) needs to earn 6.58% before taxes to double the investment after taxes in 10 years. *See* Column E in above Table 3. Stated differently, a 10% improvement in annual pre-tax return is necessary for a 100% turnover fund to equal a 5% annual turnover fund, if the fund is located in a grantor trust and if the remaining unrealized income is taxed after the grantor's death (*see* column E(2)). Contrast

this result with those same funds being held in the taxpayer's estate, if those same types of funds are subject to estate taxes. If the funds are subject to estate taxes, a 5% turnover will need to annually earn 11.78% before taxes to double the investment after taxes in 10 years, and the high 100% turnover fund will need to annually earn 19.04% before taxes to double the investment after taxes in 10 years. *See* Column B. A 61.62% annual pre-tax improvement in return is necessary for a 100% turnover fund to equal a 5% annual turnover fund, if the fund is fully taxable in the investor's estate (*see* column B(2)). The difference between 10% annual pre-tax needed improvement and 61.62% annual pre-tax needed improvement is obviously significant in determining where to locate a 100% turnover fund.

Similarly, Table 4 below illustrates, if the investor dies in 10 years, the annual interest required for a bond fund to grow by one-third after-tax, depending where a fund is located, and whether the fund interest is tax-free (*also see* attached Schedule 7).

Table 4

	Annual Interest Rate Required on an Initial $1mm Bond Fund Investment to Equal $1.34mm for Investor's Beneficiaries for an Investor Who Dies in 10 Years[1], Depending Upon How a Fund is Located, and Percentage Improvement to Equal Tax Free Bond Fund [2]					
	No Estate Planning Fund is Owned by Investor		Estate Planning Techniques (Fund is Not Subject to Estate Taxes)			
Type of Bond Investment Fund	Fund is Owned by Investor and is Fully Taxable in the Investor's Estate		Fund is Held in a Grantor Trust at Investor's Death		Fund is Held in a Non-Grantor Trust; or Fund is Owned by Investor and Investor's Estate is Lower than Remaining Estate Tax Exemption; or a Bequest of Fund is Made to Charity at Investor's Death	
	A		B		C	
	(1)	(2)	(1)	(2)	(1)	(2)
Tax Free Bond Fund	8.40%	N/A	3.00%	N/A	3.00%	N/A
Taxable Bond Fund	14.19%	68.92%	3.97%	32.42%	5.07%	68.92%

(1) These calculations ignore the effect of investment management fees, state income taxes and investment friction costs. These calculations assume the estate planning vehicles are created without paying gift taxes.
(2) % improvement necessary to equal tax free bond fund.

c. Location of tax inefficient classes in a grantor trust and managing the grantor trust through substitution strategies, further enhances the after tax advantage of a low turnover index fund.

As Column C(1) in Table 4 demonstrates the lowest pre-tax rate of return that is required to more than double the fund assets after 10 years is 5.65%, if a low turnover fund (e.g., a 5% turnover fund) is held in a grantor trust and if cash is substituted for the fund before the grantor's

death. This is a classic example of the synergistic power of estate planning when it is coupled with a basis enhancing strategy.

d. Flexibility could also be achieved by converting the note to a note with a different interest rate, a private annuity, purchasing assets owned by the trust and/or renouncing the powers that make the trust a grantor trust.

The note retained by the grantor could also be structured and/or converted to meet the grantor's consumption needs, without additional gift taxes, as long as the restructuring is for adequate and full consideration. For instance, the note at a future time could be converted to a private annuity to last the grantor's lifetime. That conversion should be on an income tax free basis since, as noted above the trust and any consideration received for any sale to the trust are ignored for income tax purposes. The note could also be restructured to pay a different interest rate, as long as the new rate is not lower than the AFR rate or higher than the fair market value rate. If the grantor cannot afford to pay the trust's income taxes in the future, the trust could be converted to a complex trust that pays its own income taxes. However, converting the trust to a complex trust could have income tax consequences if the then principal balance of the note is greater than the basis of the assets that were originally sold. That difference will be subject to capital gains taxes.[35]

e. As long as the grantor trust can maintain its grantor status it is paying back the note with pre-income tax dollars.

f. Grantor's payment of the income taxes associated with the taxable income of a grantor trust does not constitute a taxable gift.

The grantor's payment of income taxes is not a voluntary act of transfer. It is required under the income tax laws. Hence, that payment is not a taxable gift to the beneficiaries of the trust. *See* Rev. Rul. 2004-64 (I.R.B. 2004-27).

C. Considerations of the Technique.

1. A donor, under the SIDGT or the LAIDGT, may retain investment control of the family's assets and may also retain limited control of any distributions from the transferred entity interests to family members, if that limited control is compliant with IRC Sec. 2036(a)(2).

A donor, under the SIDGT or the LAIDGT techniques, may retain investment control of the family's assets and may also retain limited control of any distributions from the transferred entity interests to family members, if that limited control is compliant with IRC Sec. 2036(a)(2) and IRC Sec. 2038. The holding of *Powell v. Comm'r*, 148 TC 18 (2017) needs to be considered.

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[35] *See* Treas. Reg. Section 1.1001-2(e), Ex. 5; ***Madorin v. Commissioner***, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 722.

That case held, if there is not a substantive nontax reason for the creation of the partnership, that a decedent's right to amend a limited liability agreement and/or terminate the agreement, with the consent of all other partners, was a retained interest within the meaning of IRC Sec. 2036(a)(2). It should be noted that many commentators have criticized that holding. The Supreme Court held in *Helvering v. Helmholz,* 295 U.S. 93 (1935), that a joint power to alter beneficial enjoyment, amend an agreement or terminate an agreement is not sufficient to produce inclusion in the gross estate if it merely reproduces rights already available under applicable state law. Therefore, the *Powell* holding that the partners collective right to terminate the partnership agreement by unanimous agreement resulted in estate taxation under IRC Secs. 2036 or 2038 may be in error because under state law partners always have that right. *See also Tully Estate v. Comm'r,* 528 F.2d 1401 (Ct. Cl. 1976).

However, the cautious taxpayer could adopt one or more of the following safe harbor strategies from application of IRC Secs 2036(a)(2) and 2038 that the IRS, through its revenue ruling process, or Congress, through its legislative history, has provided:

a. If a donor is a general partner of a partnership, or is a managing member of a FLLC, he or she may retain a distribution power if that distribution power is subject to a standard in the organizing documents that could be enforced by a court (*see* the Supreme Court holding in *Byrum*[36] and Revenue Ruling 73-143, 1973-1 C.B. 407); and/or

b. There could be two different classes of managing member interests with the donor retaining a Class A managing member interest that all management powers (including investment management powers) that are not delegated to the Class B managing member interest; the Class B managing member interest has distribution, amendment and liquidation powers. The Class B managing member interest could be contributed by the donor to a trust in which a family member (other than the donor) or family advisor is the trustee; the donor could have the right to remove and replace the trustee, as long as the replacement is not related or subordinate (*see* Revenue Ruling 95-98, 1995 C.B. 191); and/or

c. The general partnership interest or managing member interest, that has the distribution power and the liquidation power, could be contributed by the donor to a corporation; the corporation's organizational documents should have normal fiduciary duties for management and the stockowners; under those circumstances, the donor could own the voting stock and his transferees could own

[36] *United States v. Byrum,* 408 U.S. 125 (1972).

the nonvoting stock (*see* the above noted Supreme Court holding in *Byrum* and Revenue Ruling 81-15, 1981-1 C.B. 457); and/or

d. It was Congressional intent when it repealed IRC Sec. 2036(c) in 1990 that IRC Secs. 2036(a)(1) or (a)(2) should not apply if the donor recapitalizes an entity in which the only retained interest of the donor in the entity is a voting preferred interest that entitles the donor to a majority vote.[37]

2. There may need to be substantive equity in the trust from prior gifts (is 10% equity enough?) before the sale is made.

The note needs to be treated as a note for tax purposes. Generally, estate and gift tax law follows state property law.[38] Thus, there needs to be a strong likelihood that the note will be paid and the capitalization of the trust should not be too "thin."[39] If the assets of the trust are almost equal to the value of the note, the note may not be considered a note under equitable tax principles, but rather a disguised interest in the trust. If the note is considered a disguised interest in the trust, the provisions of the trust and the note may not satisfy the requirements of IRC Sec. 2702 and, thus, all of the assets of the trust could be considered as having been given to the donees (the remainder beneficiaries of the trust) without any offsetting consideration for the

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[37] Congressional Record, 101st Congress S.3113: pp 1-4 (Oct. 17, 1990).

[38] *See United States v. Bess*, 357 U.S. 51 (1958); *Morgan v. Commissioner*, 309 U.S. 78 (1940).

[39] In the corporate context *see* IRC Sec. 385(b); *Miller v. Commissioner*, T.C. Memo 1996-3, 71 T.C.M. (CCH) 1674; *see also* IRC Sec. 385 (titled "Treatment of Certain Interests In Corporations As Stock or Indebtedness"); Notice 94-47, 1994–1 C.B. 357. *See also*, Staff of the Joint Committee on Taxation, "Federal Income Tax Aspects of Corporate Financial Structures," JCS-1-89, at 35-37 91989), noting that various courts have determined that the following features, among others, are characteristic of debt:

> 1) a written unconditional promise to pay on demand or on a specific date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest; 2) a preference over, or lack of subordination to, other interests in the corporation; 3) a relatively low corporate debt to equity ratio; 4) the lack of convertibility into the stock of the corporation; 5) independence between the holdings of the stock of the corporation and the holdings of the interest in question; 6) an intent of the parties to create a creditor-debtor relationship; 7) principal and interest payments that are not subject to the risks of the corporation's business; 8) the existence of security to ensure the payment of interest and principal, including sinking fund arrangements, if appropriate; 9) the existence of rights of enforcement and default remedies; 10) an expectation of repayment; 11) the holder's lack of voting and management rights (except in the case of default or similar circumstance); 12) the availability of other credit sources at similar terms; 13) the ability to freely transfer the debt obligation; 14) interest payments that are not contingent on or subject to management of board of directors' discretion; and 15) the labelling and financial statement classification of the instrument as debt. Some of these criteria are the same as those specified in §385, but this elaboration is a more extensive summary of the factors applicable in making the determination.

See also the discussion of what constitutes a valid indebtedness in *Todd v. Comm'r.*, T.C. Memo 2011-123, aff'd per curiam 486 Fed. App. 423 (5th Cir. 2012).

value of the note. If the note is considered a disguised retained beneficial interest in the trust, instead of a note, the IRS may take the position that IRC Secs. 2036 and/or 2038 apply on the death of the taxpayer.[40] Based on a private letter ruling in 1995[41] and the statutory make-up of IRC Sec. 2701, many practitioners and commentators seem to be comfortable with leverage that does not exceed 90%.[42]

3. State income tax considerations.

Many states that have a state income tax have similar provisions to the federal tax law with respect to grantor trusts, but it is not clear all states would follow the logic of Rev. Rul. 85-13. Thus, there could be state income tax consequences with the sale, whether there are capital gains consequences and/or there could be a mismatch of the interest income and interest deduction associated with any sale.

4. There may be capital gains considerations with respect to the note receivables and/or note payables that may exist with the grantor trust at the death of the donor, but not with the LAIDGT technique (*see* the discussion *supra* Section IV.B).

Under the facts of Revenue Ruling 85-13, 1985-1 C.B. 184, a grantor of a trust purchases all of the assets of that trust in consideration for an unsecured promissory note. The purchase is done in a manner that makes the trust a grantor trust. The key issue to be decided by the IRS in the revenue ruling is as follows:

> To the extent that a grantor is treated as the owner of a trust, *whether the trust will be recognized as a separate taxpayer capable of entering into a sales transaction with the grantor*. (Emphasis added.)

The IRS determined that for income tax purposes the trust was not capable of entering into a sales transaction with the grantor as a separate taxpayer. The Revenue Ruling then cited some old cases for the common sense proposition that a taxpayer cannot enter into transactions with himself for income tax purposes and have it recognized. The trust would not be capable of entering into a sales transaction for income tax purposes as a separate taxpayer until the moment

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[40] The IRS made that argument in *Karmazin* (T.C. Docket No. 2127-03, 2003), but the case was settled on terms favorable to the taxpayer. In *Dallas v. Commissioner* (T.C. Memo 2006-72) the IRS originally made that argument, but dropped the argument before trial. The IRS also made that argument in two docketed cases, *Estate of Donald Woelbing v. Commissioner* (Docket No. 30261-13) and *Estate of Marion Woelbing v. Commissioner* (Docket No. 30260-13), but the case was settled. Also *see Bixby v. Commissioner*, 58 TC 757 (1972) in which the full Tax Court, in a highly leveraged sale to a trust, recast the seller as a beneficiary of the trust for income tax purposes. While this is an income tax case, there is a similar analysis for IRC Sec. 677 purposes and IRC Sec. 2036 purposes.

[41] PLR 9535026 (May 31, 1995).

[42] *See* Martin Shenkman, "Role of Guarantees and Seed Gifts in Family Installment Sales," 37 Estate Planning 3 (Nov. 2010).

of the grantor's death. For income tax purposes, the trust itself is not created and recognized as a separate taxpayer until the moment of the death of the grantor.

If a grantor sells low basis assets to a grantor trust for a note, and if there is an outstanding note **receivable** at death that exceeds the basis of the assets that were sold, is there a capital gains transaction at death when the grantor trust converts into a trust that is for the first time recognized for income tax purposes? The grantor's death is the event, for income tax purposes, that first causes the asset contribution to the trust to be recognized and first causes the sale of certain of those assets to the trust for a note to be recognized. Consider the following analogous example: a decedent directs in his will that his executor contribute certain assets to a trust and sell certain assets to that trust. There would not be any income taxes to the decedent's estate with that sale. Is that the proper analysis when there is an outstanding receivable from a grantor trust at the grantor's death? There is no definitive authority on that question and there is a debate among the commentators as to the correct assumption.[43]

To the extent this is a concern, the note could be paid in-kind by the trust before the death of the grantor (perhaps with a low basis asset that will receive a basis step-up on the death of the grantor). Also, if this is a concern, it could be mitigated by the trustee of the grantor trust borrowing cash from a third party lender and using that cash to eliminate the note owed by the trust to the grantor. The grantor could then use that cash to buy the lowest basis assets owned by the trust. The trustee of the trust could then use the cash it received from the grantor for its purchase of the lowest basis assets to retire its third party lender debt.

If a grantor purchases a low basis asset from a grantor trust, what is the trust's basis in any note **payable** to the trust by the decedent grantor at the moment of death? The grantor's death is the event, for income tax purposes, that first causes the asset contribution to the trust to be recognized and first causes the purchase of certain of those assets to the trust for a note to be recognized. Consider the following analogous example: a decedent directs in his will that the executor create a trust with part of the assets of his estate. The decedent then directs that the executor purchase certain of those assets from the trust with a note. The decedent finally directs the executor to pay the note with other assets of his estate. There would not be any income taxes recognized by the trust with that payment. Is that the proper analysis in determining the tax

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[43] Compare Cantrell, *Gains is Realized at Death*, TR. & ESTS. 20 (Feb. 2010) and Dunn & Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, 95 J. TAX'N (July 2001) with Gans & Blattmachr, *No Gain at Death*, TR. & ESTS. 34 (Feb. 2010); Manning & Hirsch, *Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts; Income and Transfer Tax Elements*, 24 TAX MGMT. EST., GIFTS & TR. J. 3 (1999); Hatcher & Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152, 161-64 (2000); Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149 (Sept. 2002).

It should be noted that in addressing the relevance of Reg. § §1.1001-2(c) Ex. 5, *Madorin*, 84 T.C. 667 (1985) and Rev. Rul. 77-402, the author(s) of CCA 200923024 observed:

> "We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner **which is generally not treated as an income tax event**." (emphasis added).

consequences of a payment of a note payable to a grantor trust upon the grantor's death, which is the moment when all of the transactions are first recognized for income tax purposes? Again, there is no definitive authority on what the trust's basis in a note payable to the trust is at the moment of death, and the possibility exists that a court could find that the basis of the note is equal to the basis of the trust assets sold to the grantor at the time of the purchase.

To the extent this is a concern, it could be mitigated by the grantor borrowing cash from a third party lender and using that cash to eliminate the note owed to the trust. At a later time, perhaps after the trust is converted to a complex trust for income tax purposes, the grantor (or his executor) could borrow the cash from the trust and pay the third party lender. If the trust, at that later time, does loan cash to the grantor or the executor of the grantor's estate, the trust's basis in that note should be equal to the cash that is loaned. (*See* discussion *infra* Section VIII.)

5. On the death of the grantor there will be no step-up in basis in the assets owned by the grantor trust.

6. The IRS may contest the valuation of any assets that are hard to value that are donated to a grantor trust or are sold to such a trust.

    a. The problem and a probable solution: defined allocation transfers.

The IRS will almost always scrutinize significant transfers of "hard to value" assets. Reasonable people (and, of course, unreasonable people) can differ on the value of certain assets (*e.g.*, a FLP interest). From the IRS's point of view, scrutiny of those assets may represent a significant revenue opportunity. One approach that may reduce the chance of an audit of a transfer of a hard to value asset, or a gift tax surprise, if an audit does occur, is to utilize a formula defined value allocation transfer.[44] A formula defined value allocation transfer may increase the retained interest of the donor (as in the case of a grantor retained annuity trust); may define the portion of the property interest that is transferred or may provide that a defined portion of the property transferred passes to a "tax sheltered recipient." For example, a transfer may provide that an undivided part of a "hard to value" asset, which exceeds a defined value of the transferred entity interest, will pass either to a grantor retained annuity trust,[45] the transferor's spouse,[46] charity[47] or a trust in which the grantor has retained an interest that makes the gift incomplete.[48]

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[44] *See* S. Stacy Eastland, "*The Art of Donating Your Cake to Your Family and Eating it Too: Current Gift Planning Opportunities Using Strings That Are Not Considered Attached by the Donor*" 47th Annual Heckerling Institute on Estate Planning ¶ 602.2[c]5 (June, 2013).

[45] *E.g.,* the excess could be transferred to a grantor retained annuity trust under IRC Sec. 2702 that is nearly "zeroed out" with respect to the grantor and uses the required revaluation clause in the trust agreement with respect to a retained annuity.

[46] *E.g.,* the excess could be transferred to a spouse or a marital deduction trust pursuant to a formula marital deduction clause.

[47] *E.g.,* the excess could be transferred to a charity. *See McCord v. Commissioner,* 120 T.C. 358 (2003); *Estate of Christianson v. Commissioner,* 130 T.C. 1 (2008), aff'd 586 F.3d 1061 (8th Cir. 2009); *Hendrix v.*

"Formula defined value allocation" clauses should be distinguished from "reversion" clauses like the ones discussed in Revenue Ruling 86-41, 1986-1 C.B. 442, and in *Procter*.[49] In Rev. Rul. 86-41, the IRS said that a clause that increased the consideration to be paid for the transferred property, or that caused a portion of the transferred property to revert to the transferor, were conditions subsequent that are not effective to circumvent a taxable gift from being made on the transfer of the property. By contrast, formula clauses defining the amount of the transfer or the identity of the transferee are ubiquitous in the transfer tax context. In fact, such arrangements are specifically permitted in the tax law. [50] If an adjustment occurs in a formula defined value allocation clause, a change in the identity of the transferee may occur (*e.g.*, the credit shelter trust owns less of the asset and the marital trust owns more of the asset). If an adjustment occurs in a price adjustment clause, the initial transfer is partially unwound and the identity of the transferee does not change (*e.g.*, the transferee pays an additional amount for the asset). Price reimbursement clauses were found to be against public policy in *Procter* because, if such clauses were effective, the result of an audit of the gift tax return could never result in a deficiency and there is no other penalty of assets passing to a different transferee. Although part of the same public policy argument applies to formula defined value allocation clauses, they are so commonly used that an argument that they are void is not persuasive. Secondly, the public policy argument could be addressed by deliberately structuring the formula to produce a small deficiency on audit. Thirdly, formula clauses have a penalty in that the transferred assets could pass to an unintended transferee.

Any formula defined value allocation clause needs a mechanism to bring finality to the question of who owns what. Where the transfer involves a gift, finality can be achieved by filing a gift tax return that adequately discloses the formula transfer. When the statute of limitations expires on assessing a gift tax deficiency and none has been asserted, the ownership fractions will have been determined. If there is no gift tax return, however, finality cannot be achieved unless

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Commissioner, T.C. Memo 2011-133, 101 T.C.M. (CCH) 1642; *Estate of Petter v. Commissioner*, T.C. Memo 2009-280, 99 T.C.M. (CCH) 534.

[48] David A. Handler & Deborah V. Dunn, "The LPA Lid: A New Way to 'Contain' Gift Revaluations," 27 Estate Planning 206 (June 2000).

[49] *See Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944); *see* also *Ward v. Commissioner*, 87 T.C. 78 (1986).

[50] *See* Treas. Reg. §25.2518-3(c) (allowing defined value formula for disclaimer of pecuniary amount); Treas. Reg. §25.2702-3(b)(2) (allowing value of grantor retained annuity trust annuity to be stated in terms of a fraction or percentage of fair market value); Treas. Reg. §25.2702-39(c)(2) (requiring the annuity of a grantor retained annuity trust to be increased if an incorrect determination of the fair market value of the trust assets is made); Rev. Proc. 64-19, 1964-1 C.B. 682 (relating to defined value formula for funding the marital deduction); Treas. Reg. §1.664-2(a)(1)(iii) (allowing defined value dollar amount of charitable remainder annuity trust to be expressed as a fraction or percentage of the initial net fair market value of the property passing in trust as finally determined for Federal tax purposes); Rev. Rul. 72-395, 1972-2 C.B. 340, 344, modified by Rev. Rul. 80-123, 1980-1 C.B. 205 and Rev. Rul. 82-128, 1982-2 C.B. 71 (allowing value definition clauses in charitable remainder trusts); Treas. Reg. §1.664-3(a)(1)(iii) (requiring adjustments in annuity amounts if an incorrect determination of the fair market value of the charitable remainder trust has been made).

there is another mechanism that does not involve any action by the transferor that can be viewed as donative.

b. A second probable solution: a defined dollar transfer.

Technical Advice Memorandum 86-11-004[51] illustrates the effect of a defined value clause when the excess value above the defined value accrues to the donor, instead of to a spouse or a charity. Under the facts in Technical Advice Memorandum 86-11-004, a man ("the donor") transferred a sole proprietorship to a partnership in exchange for a 99.9982% interest in the partnership. The other .0018% interest in the partnership was owned by trusts for the donor's children. The donor transferred a portion of his partnership interest equal to a stated dollar amount to the trusts for his children each year from 1971 through 1982. The donor and trustees agreed on the capital ownership attributable to the gifts, and partnership income was allocated accordingly. The IRS concluded that the interests transferred by the donor were those having a fractional equivalent to the stated fair market values of the gifts, based upon the fair market value of the partnership at the time of each gift determined according to recognized valuation principles. The donor's interest extended to the rest of the partnership because he could have asserted ownership to the extent that the gifted fractional interests reflected in the partnership agreement and income tax returns exceeded the fractional interests actually conveyed in the gift assignments. If, however, he were ever barred from enforcing his ownership right to the excess interest, he would be treated as having made an additional gift to the trusts. To the extent that income was allocated to the donees in an amount exceeding the partnership interest to which they were actually entitled, the donor made gift assignments of the income, with the implicit right to revoke the assignments by asserting his right to the excess partnership interest. Therefore, according to the Technical Advice Memorandum the gifts of income were to be regarded as complete when each distribution of excess income became irrevocable as a result of the lapse of the statute of limitations.

The recent *Wandry v. Commissioner* case (T.C. No. 10751-09, T.C. Memo. 2012-88, March 26, 2012, nonacq.) partially overrules Technical Advise Memorandum 86-11-004 to the extent it holds that a gift is made when the statute of limitations expires, if the transferred percentage interest of the enterprise exceeds the fair market value of the dollar formula transfer.

On January 1, 2004, Joanne and Dean Wandry executed separate assignments and memorandums of gifts ("gift documents"). Each gift document provided:

> I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:

[51] Tech. Adv. Mem. 8611004 (Nov. 15, 1985).

Name	**Gift Amount**
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	$261,000
Jason K. Wandry	$261,000
Jared S. Wandry	$261,000
Grandchild A	$11,000
Grandchild B	$11,000
Grandchild C	$11,000
Grandchild D	$11,000
Grandchild E	$11,000
Total Gifts	**$1,099,000**

> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

The Tax Court opinion was written by Judge Haines. Judge Haines addressed the IRS arguments and concluded:

> Absent the audit, the donees might never have received the proper [LLC] percentage interests they were entitled to, but that does not mean that parts of petitioners' transfers were dependent upon an IRS audit. Rather, the audit merely ensured that petitioners' children and grandchildren would receive the 1.98% and .083% [LLC] percentage interests they were always entitled to receive, respectively.
>
> It is inconsequential that the adjustment clause reallocates membership units among petitioners and the donees rather than a charitable organization *because the reallocations do not alter the transfers*. On January 1, 2004, each donee was entitled to a predefined [LLC] percentage interest expressed through a formula. The gift documents do not allow for petitioners to "take property back". Rather, the gift documents correct the allocation of LLC membership units among petitioners and the donees because the [business appraiser] report understated

[the LLC's] value. The clauses at issue are valid formula clauses. [emphasis added]

Finally, Judge Haines rejected the Procter public policy argument that the IRS made, stating that "[t]he lack of charitable component in the cases at hand does not result in a 'severe and immediate' public policy concern."

c. A third probable solution: defined value allocation clauses involving both a defined dollar transfer by the donor and a parallel formula qualified disclaimer by the donee.

What if donor made a defined dollar gift and the donee also engaged in a parallel formula disclaimer? Consider the following example:

Example 3: Defined Dollar Formula by a Donor and a Parallel Qualified Formula Disclaimer by the Donee Trust

Grant Gratuitous makes a defined dollar formula gift of that amount of partnership interests that are equal to $5,000,000 patterned on the Wandry case. The gift assignment is made to a trust. The trust document provides that the current beneficiaries of the trust have the power to disclaim any contributed property, and if any property is disclaimed, it will revert to the grantor of the property and the disclaimed property will be held in an agency capacity by the person who is the trustee until the property is returned to the grantor. At the same time the assignment is made, those beneficiaries execute a qualified formula disclaimer using the same parallel language in the dollar-defined assignment, with any disclaimed amount reverting back to Grant Gratuitous. The trust document provides that the trustee does not have to accept any additional property (and presumably any interest in property in excess of the original "Wandry" assignment is additional property). The trust document also provides that any disclaimed property that is held in an agency capacity may be comingled with the trust property, until it is returned to the grantor.

The argument for using the formula disclaimer by the current beneficiaries of the trust, which parallels the formula of the *Wandry* assignment, is that the public policy concerns of the *Wandry* technique, and the concerns that the IRS has nonacquiesced in the *Wandry* case result, could be ameliorated with a companion formula disclaimer. The IRS has blessed formula disclaimers, if the disclaimed gift has not been accepted. *See* Treas. Reg. §25.2518-3(b), examples 15 and 20. A defined value disclaimer was approved in *Estate of Christiansen v. Comm'r*, 586 F.3d 1061 (8th Cir. 2009). The advocates for the technique also note that the *Wandry* formula assignment by the grantor (plus any exculpatory language in the trust document) should counter any concern that the trustee has breached a fiduciary duty by not accepting any property subject to the formula assignment and formula disclaimer by the current beneficiaries of the trust. The *Wandry* formula assignment is evidence that the grantor did not desire for a trust relationship to exist for any property that is not assigned as per the formula in the original *Wandry* formula assignment.

If, at a later time, it is finally determined that the original assumptions as to the percentage interest of the FLP that was assigned to the trust is excessive, the trustee will assign those extra interests (that are held under the trust document in an agency relationship) back to the grantor. Under state property law, and the trust document, it would seem that the disclaimed property has not been accepted as trust property and was only accepted in an agency capacity. If the disclaimed property is never accepted as trust property under the above Treasury regulations, the disclaimer would appear to be a valid disclaimer and any unanticipated gift tax consequences of the assignment is avoided.

The combination of formula gift and formula disclaimer affords "belt-and-suspenders" protection for the transfer. If the "belt" of the formula gift proves ineffective, the "suspenders" of the disclaimer by the current trust beneficiaries should by itself be adequate to prevent revaluation of the FLP from resulting in a gift that exceeds the original stated dollar value. As discussed above, it seems very difficult for the IRS to argue that the disclaimer is invalid because the trustee has violated its fiduciary duty in accepting it. It may still be open to the IRS to argue that the beneficiaries have no rational reason to make the disclaimer and is acting in concert with Grant Gratuitous to deprive the IRS of the incentive and ability to enforce the gift tax law, in violation of public policy, a central *Procter* concern. If the transfer took the form of net gift, and if the donated asset is illiquid (as most hard to value assets are) the beneficiaries of the trust would have a rational personal motive for the disclaimer, which is to manage and limit the trust's own gift tax liability.

IV. CONTRIBUTION OF A LEVERAGED ASSET TO AN INTENTIONALLY DEFECTIVE GRANTOR TRUST ("LAIDGT").

A. The Technique.

In order to protect against a note in the SIDGT technique being declared a disguised retention of an equity interest in a trust under equitable tax principles, the donor could first create a leveraged entity with a convertible note (the note could be convertible to that number of non-managing units equal to the outstanding principal of the note at the option of the holder) and then contribute an interest in that entity to a grantor trust. This technique is a very powerful estate planning technique whose estate planning results are very similar to the SIDGT technique. One consideration of the SIDGT technique is whether the note will be treated as a retained interest in the obligor trust, because of thin capitalization or other reasons, with disastrous transfer tax consequences, which may not exist with the LAIDGT technique. *See* the discussion *supra* Section III.C.1. If the retained note is treated as equity in the LAIDGT technique, because of thin capitalization, or for some other reason, the retained equity interest is a retained interest in a FLLC, not a retained interest in a trust. The disappointment in the LAIDGT technique, if the retained note is treated as retained equity, will be that not as much equity as the taxpayer wished will be transferred to a trust for his descendants. Secondly, since the note is convertible to that number of non-managing units equal in value to the then outstanding principal of the note there may not be any valuation issues with respect to the note. There are also some powerful income tax and basis enhancing advantages to using this technique in comparison to the SIDGT technique.

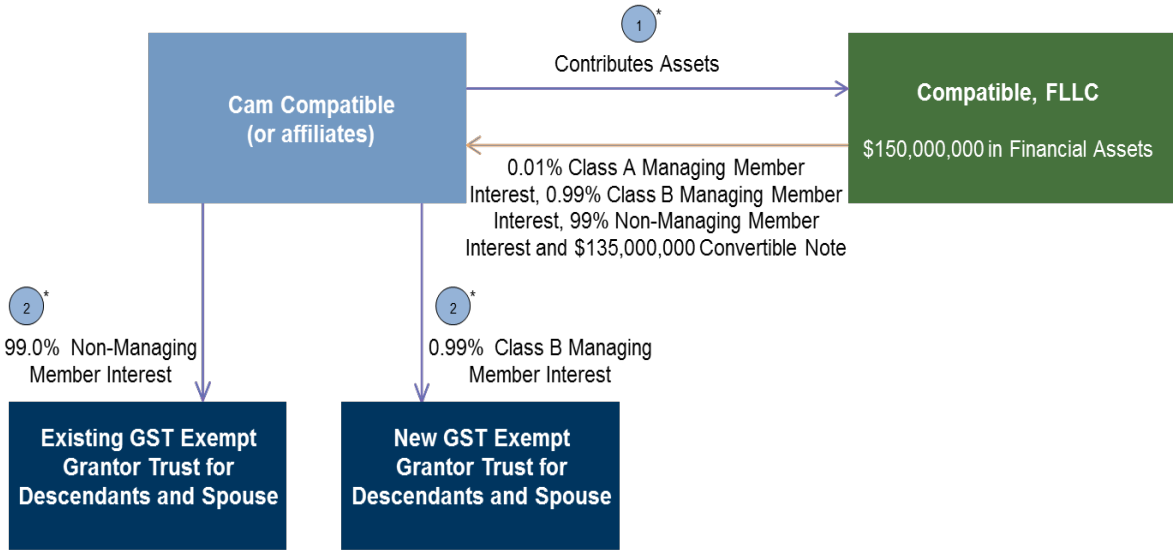
Consider the following example:

Example 4: Cam Compatible Creates a Leveraged Single Member LLC With a Convertible Note and Then Contributes His Non-Managing Interests to a Grantor Trust

Cam Compatible owns $150,000,000 in financial assets. Cam and affiliates (who are not recognized for income tax purposes) contribute $150,000,000 in assets to a FLLC and receive a 0.1% Class A managing member interest, a 0.99% Class B managing member interest, a 99% non-managing member interest and a $135,000,000 convertible note (Transaction 1). The note could be converted at any time at the option of the holder to that number of Compatible, FLLC units that are equal in value to the then outstanding principal of the note. The note could have a mandatory conversion feature at the death of the holder of the note. In a separate, independent and distinct transaction (Transaction 2) Cam contributes his 99% non-managing member interest to a grantor trust. Like Example 2, the trust treats his wife, Carolyn, as the discretionary beneficiary and gives her certain powers of appointment over the trust.

Due to considerations with respect to retaining entity distribution, amendment and liquidation powers, Cam could retain the 0.01% Class A managing member interest and transfer the 0.99% Class B managing member interest. The Class A managing member interests would control all entity managing member decisions, including investment management decisions that are not delegated to the Class B managing member interest. The Class B managing member interests would control all distribution, amendment and liquidation decisions.

Cam could give his Class B managing member interest to a grantor trust in which the initial trustee is an advisor or family member he trusts. Cam could have the power to replace the trustee of that donee trust with a new trustee, as long as the replacement trustee is not related or subservient. Assuming a 25.5% valuation discount for the transferred member interests, the technique is illustrated below:



* These transactions need to be separate, distinct and independent.

B. Income Tax and Basis Enhancing Advantages of the Technique.

1. It has all of the income tax and basis enhancing advantages of the SIDGT technique.

See the discussion *infra* Section III.B.

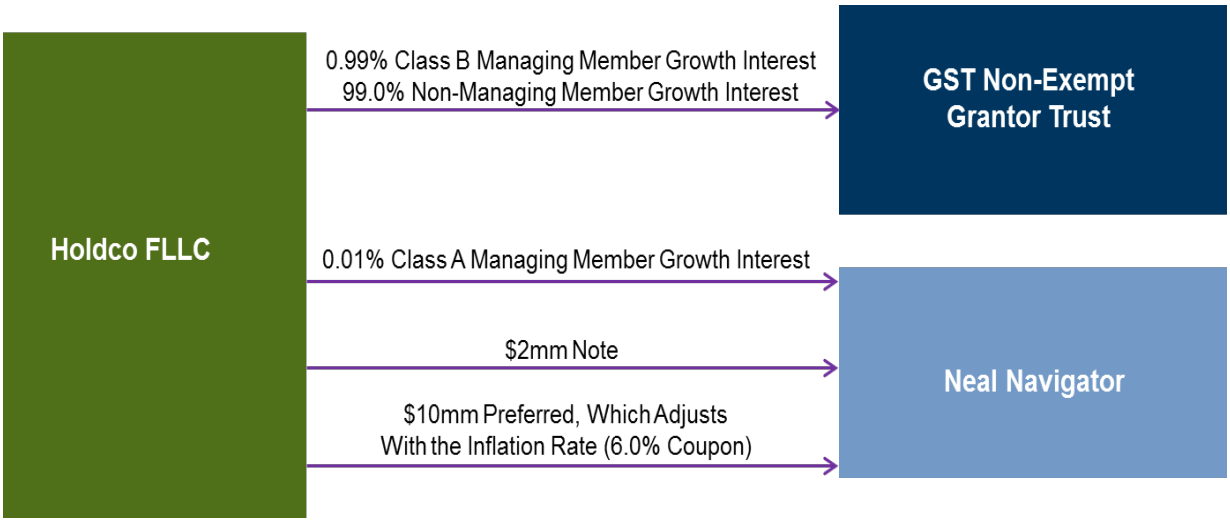
2. There is an inherent flexibility to enter into basis enhancing strategies with the LAIDGT.

The principal and interest of the donor's retained note may be paid with either cash or in kind. There will not be any income tax consequences with in kind payments, if the FLLC remains a disregarded entity. If low basis assets owned by the FLLC are used to make some of those in kind payments, and if those low basis assets are retained by the grantor until the grantor's death, there will be a step-up in basis of those assets on the grantor's death under IRC Sec. 1014.

Another basis enhancing strategy opportunity with the LAIDGT technique is to convert part or all of the retained note at some point to a preferred member interest in the FLLC. The preferred interest, in order to avoid gift tax issues, needs to be compliant with IRC Sec. 2701 and Revenue Ruling 83-120.[52] In this example, assets with an underlying value of approximately $25,000,000 were contributed to the single member FLLC. Assume in this example that Neal Navigator and his wife, Nancy, need annual cash flow equal to $600,000 a year for their consumption needs. Assume in a future year that the retained note has been reduced from $16,724,700 to $12,000,000. Neal could convert $10,000,000 of the $12,000,000 note to a $10,000,000 preferred non-managing member interest that pays a 6% annual coupon without any income taxes associated with the conversion because the FLLC is a disregarded entity for income tax purposes. The principal of the preferred could be designed to annually increase at the same rate the exemption increases. In this manner, assuming Neal and Nancy have not used any of their exemption in this technique, or any other technique, they will be in a position to eliminate the estate tax. The $2,000,000 in retained notes that are not converted to a preferred interest could be used to pay income taxes associated with the FLLC investments. At some point, distributions from the remainder grantor trust could also be made to Nancy to also pay for Neal and Nancy's income taxes. On Neal's death, his basis in the preferred will receive a step-up in basis equal to the fair market value of the preferred. The FLLC could make an IRC Sec. 754 election and receive a basis step-up of some of its assets commiserate to the step-up in basis of Neal's preferred.

This example, after the conversion of $10,000,000 of the $12,000,000 note, is illustrated below:

[52] Rev. Rul. 83-120, 1983-2 C.B. 170.



Finally, the original note payable by Holdco could be designed to be a convertible note that is convertible at the election of the holder of the note to be converted to that amount of non-managing units of Holdco that are equal in value to the then outstanding principal balance of the note. Secondly, the note could be designed to have a mandatory conversion feature on the death of the holder of the note to that amount of non-managing units of Holdco that are equal in value to the then outstanding principal balance of the note.

The chief advantage of designing the note with those conversion features are the following:

a. That conversion feature would support the value of the note.

b. That conversion feature would give the holder additional flexibility to participate in the future growth of Holdco.

c. On the death of the holder of the note, the holder could make an IRC Sec. 754 election and receive a basis step-up of some of its assets commiserate to the step-up in basis of the holder's converted interest in Holdco.

3. There is greater authority that a sale to a single member FLLC will be treated as a nontaxable sale to a disregarded entity for income tax purposes than there is for a sale to a grantor trust.

While many practitioners believe a sale to a grantor trust should be treated as a sale to a disregarded entity, the law is not clear that a grantor trust will be disregarded for sale purposes as it is for a sale to a single member FLLC. It is clear that a single member FLLC is disregarded for all income tax purposes, including all activities (e.g., sales to and purchases from the single member FLLC).[53] In *Rothstein v. Commissioner*[54] the Second Circuit ruled that a purchase from

[53] *See* Treas. Reg. § 301.7701-3(a); Treas. Reg. § 301.7701-3(b)(1)(ii) and Treas. Reg. § 301.7701-2(a).

a grantor trust is not ignored because the phrase under IRC Sec. 671 "shall be treated as the owner of the trust assets" *only* applied for purposes of including the trust's income and deductions and does not apply to activities with the grantor trust (e.g., sales to and purchases from the grantor trust). *See* also the commentaries of distinguished professors Mark Asher[55] and Jeff Pennell.[56]

C. Considerations of the Technique.

This technique does not have the same considerations as the SIDGT technique, except the considerations noted *supra* Sections III.C.2 or III.C.5.

V. GRANTOR RETAINED ANNUITY TRUST ("GRAT") TECHNIQUE.

A. What is the GRAT technique?

A GRAT is an irrevocable trust to which the grantor transfers an asset in exchange for the right to receive a guaranteed annuity for a fixed number of fiscal years (the "Annuity Period").[57] When the trust term expires, any GRAT balance remaining is transferred tax free to a designated remainder beneficiary (e.g., a "defective grantor trust" for the benefit of the grantor's spouse and issue).[58] If a grantor makes a gift of property in trust to a member of the grantor's family while retaining an interest in such property, the taxable gift generally equals the fair market value of the gifted property without reduction for the fair market value of the retained interest.[59] However, IRC Sec. 2702 provides that for a gift of the remainder of a GRAT in which the grantor retains a "qualified interest," defined to include a guaranteed annuity, the taxable gift will be reduced by the present value of the qualified interest, as determined pursuant to a statutory rate determined

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[54] *Rothstein v. Commissioner*, 735 F.2d 704 (2nd Cir. 1984).

[55] Mark L. Asher, When to Ignore Grantor Trusts: The Precedents, a Proposal, and a Prediction, 41 Tax. L. Rev. 253 (1986).

[56] Jeffrey N. Pennell, "(Mis) Conceptions About Grantor Trusts," 50th Annual Southern Federal Tax Institute.

[57] The GRAT may also be structured to terminate on the earlier of a period of years or the grantor's death, with a reversion of the entire corpus to the grantor's estate on premature death, but doing so will reduce the value of the retained interest.

[58] IRC Sec. 2702 provides the statutory authority for such transfers after October 8, 1990. IRC Sec. 2702(a) uses the "subtraction- out" method to value retained interests of split-interests transfers. Under IRC Sec. 2702(b), a qualified interest includes any interest that consists of a right to receive fixed amounts. The value of a remainder interest in a GRAT that meets the requirements of IRC Sec. 2702 is computed by subtracting the present value of the grantor's annual annuity payments from the contributed properties' current fair market value. The grantor must recognize a taxable gift to the extent of any computed remainder interest. The present value of the grantor's annual annuity payment is computed by discount rates set by the IRS under IRC Sec. 7520. The IRS Tables change monthly to reflect an interest rate assumption of 120% of the mid-term adjusted Federal Rate for that month under IRC Sec. 1274(d)(1).

[59] *See* IRC Sec. 2702(a)(2)(A). Absent IRC Sec. 2702, the amount of the gift would be reduced by the value of the retained interest.

under IRC Sec. 7520(a)(2) (the "Statutory Rate"). In general, Statutory Rate requires an actuarial valuation under prescribed tables using an interest rate equal to 120 percent of the federal midterm rate in effect for the month of the valuation.[60]

A grantor's ability to determine the size of the guaranteed annuity and the annuity period at the outset allows the GRAT to be constructed so that the present value of the grantor's retained interest approximately equals the value of the property placed in the GRAT, resulting in a "zeroed out" GRAT.[61] If the grantor survives the GRAT term and the GRAT earns a yield or

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[60] *See*, IRC Sec. 7520(a)(2). Certain exceptions set forth in Treas. Reg. § 25.7520-3(b) do not appear to be applicable to the facts discussed in this paper. *See* Treas. Reg. § 25.2511-1(e).

[61] The possibility of completely "zeroing out" a GRAT was negated by Example 9 of Treas. Reg. § 25.2702-3(e). Example 9 was invalidated by Walton v. Commissioner, 115 T.C. 589 (2000), acq., Notice 2003-72, 2003-44 I.R.B. 964. Final regulations reflecting Walton and containing a revised Example 9 were issued. *See* T.D. 9181, 2005-1 C.B. 717 (Feb. 25, 2005). Prior to its acquiescence, the IRS, in Rev. Proc. 2002-3, 2002-1 C.B. 117, § 4.01(51), announced that it will not issue a favorable private letter ruling in circumstances where the amount of the guaranteed annuity payable annually is more than 50 percent of the initial net fair market value of the property transferred to the GRAT or if the present value of the remainder interest is less than 10 percent of the transferred property's initial net fair market value. This item remains on the "no ruling" list. Rev. Proc. 2015-3, 2015-1 I.R.B. 129, § 4.01(53). The regulations do not include any such 50/10 limitation, nor would such a limitation be consistent with the Walton case itself, which involved a zeroed-out GRAT.

The Obama Administration proposed changes with respect to GRATs which would require that the remainder have a minimum value. Those proposed changes may appear as a result of future legislation. The ability to "zero out" (or almost zero out) the GRAT under current law would be eliminated. *See* Treasury Department, "General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals" 197-198 (Feb. 2015):

> Reasons for Change
>
> GRATs and sales to grantor trusts are used for transferring wealth while minimizing the gift and income tax cost of transfers. In both cases, the greater the post-transaction appreciation, the greater the transfer tax benefit achieved. The gift tax cost of a GRAT often is essentially eliminated by minimizing the term of the GRAT (thus reducing the risk of the grantor's death during the term), and by retaining an annuity interest significant enough to reduce the gift tax value of the remainder interest to close to zero. In addition, with both GRATs and sales to grantor trusts, future capital gains taxes can be avoided by the grantor's purchase at fair market value of the appreciated asset from the trust and the subsequent inclusion of that asset in the grantor's gross estate at death. Under current law, the basis in that asset is then adjusted (in this case, "stepped up") to its fair market value at the time of the grantor's death, often at an estate tax cost that has been significantly reduced or entirely eliminated by the grantor's lifetime exclusion from estate tax.
>
> Proposal
>
> The proposal would require that a GRAT have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years to impose some downside risk in the use of a GRAT. The proposal also would include a requirement that the remainder interest in the GRAT at the time the interest is created must have a minimum value equal to the greater of 25 percent of the value of the assets contributed to the GRAT or $500,000 (but not more than the value of the assets contributed). In addition, the proposal would prohibit any decrease in the annuity during the GRAT term, and would prohibit the grantor from engaging in a tax-free exchange of any asset held in the trust.
>
> This proposal would apply to trusts created after the date of enactment.

otherwise appreciates at a rate that exceeds the Statutory Rate, the amount of such excess value should pass to the GRAT's designated beneficiaries free of transfer tax. This is a powerful estate planning technique that may be designed to not use any meaningful transfer tax exemptions. That transfer tax exemption can then be preserved to be used at the death of the taxpayer in order to have more low basis assets receive a step-up in basis without having an estate tax cost.

Consider the following example:

Example 5: Contribution of Financial Assets or an Interest in a Closely Held Entity to a GRAT

Neal Navigator approaches his attorney, Lenny Leverage, and tells him that he would like to transfer, through the use of a GRAT, the maximum amount that he can transfer using a three-year GRAT that will terminate in favor of a grantor trust for his wife and children. Neal tells Lenny that he has around $20,000,000 in financial assets and $5,000,000 in private equity assets (for a total of $25,000,000 in assets). Neal is willing to have a significant portion of his assets subject to a three-year GRAT.

Lenny likes many of the aspects of a GRAT, including its built-in revaluation clause. Lenny also likes using FLPs, or FLLCs, because of the substantive non-tax investment and transfer tax advantages that are sometimes associated with these entities (e.g., they may effectively deal with qualified purchasers and accredited investor requirements for alternative investments and because of the possibility of valuation discounts).[62]

Lenny recommends that Neal contribute $18,000,000 of marketable securities and other financial assets to a FLP ("Transaction 1"). Due to considerations with respect to retaining entity distribution, amendment and liquidation powers, Neal could retain the 0.01% Class A general partner interest and transfer the 0.99% Class B general partner interest. The Class A general partner interest would control all entity general partner decisions, including investment management decisions that are not delegated to the Class B general partner interest. The Class B general partner interests would control all distribution, amendment and liquidation decisions.

Lenny assumes Neal's limited partnership interest in FLP will have a 35% valuation discount. Neal would then transfer the 99% limited partnership interest in FLP, together with $5,000,000 of alternative investments and $2,000,000 cash, to a single member FLLC (or "Holdco") ("Transaction 2") in exchange for a .01% Class A managing member interest, a 0.99% Class B managing member interest and a 99% non-managing member interest. Due to considerations with respect to retaining entity distribution, amendment and liquidation powers, Neal could retain the 0.01% Class A managing member interest and transfer the 0.99% Class B managing member interest. The Class A managing member interests would control all entity managing member decisions, including investment management decisions that are not delegated

[62] *See* the discussion by this author in "Some of the Best Family Limited Partnership Planning Ideas We See Out There," ALI-ABA Planning For Large Estates, at 2-32 (Nov. 15, 2010).

to the Class B managing member interest. The Class B managing member interests would control all distribution, amendment and liquidation decisions. Neal could give his Class B managing member interest to a grantor trust in which the initial trustee is an advisor or family member he trusts. Neal could have the power to replace the trustee of that donee trust with a new trustee, as long as the replacement trustee is not related or subservient. Neal contributes the non-managing interest or Holdco to a three year GRAT ("Transaction 3"). Lenny assumes that Neal's non-managing member interest in Holdco will have a 20% valuation discount. Holdco is projected to distribute 3.5% of the undiscounted value of its assets it directly or indirectly owns or around $875,000 a year ($25,000,000 x 3.5%). Three years later the GRAT terminates and the remaining assets pass to a grantor trust for the benefit of his family ("Transaction 4").

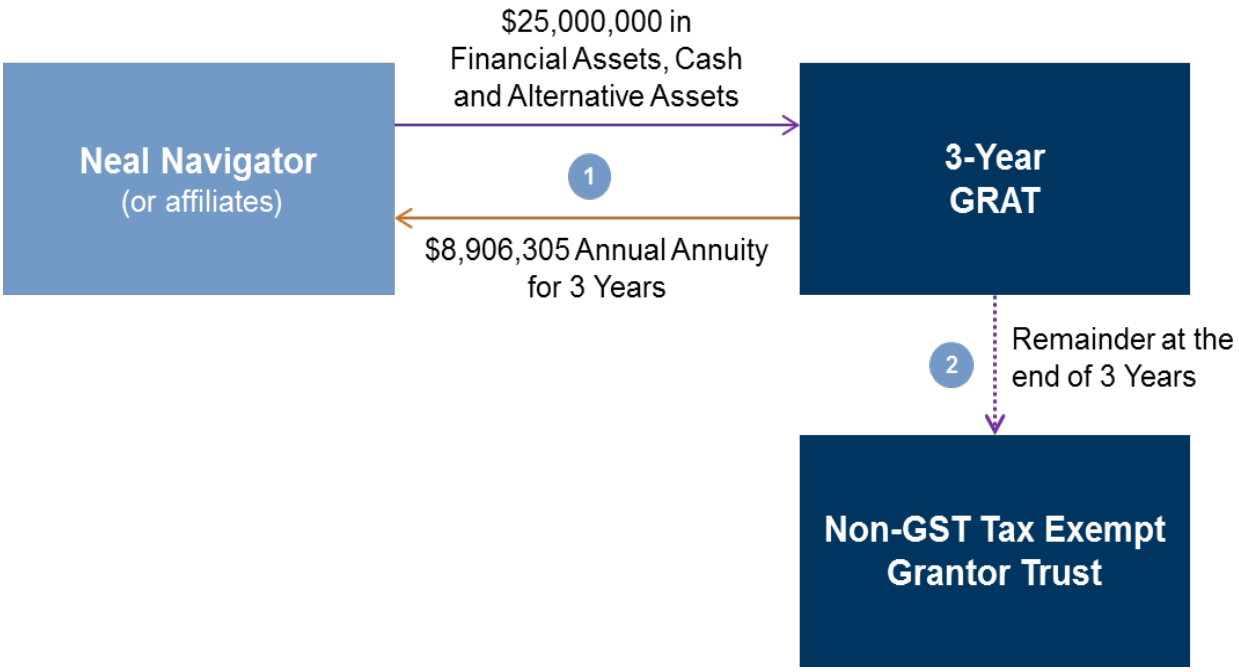
Neal would also like Lenny to illustrate the GRAT technique without creating the FLP and Holdco.

In this technique, Neal simply contributes his assets without the entity encumbrance to a GRAT (Transaction 1) and three years later the remaining assets of the GRAT terminate in favor of a grantor trust for the benefit of his family (Transaction 2).

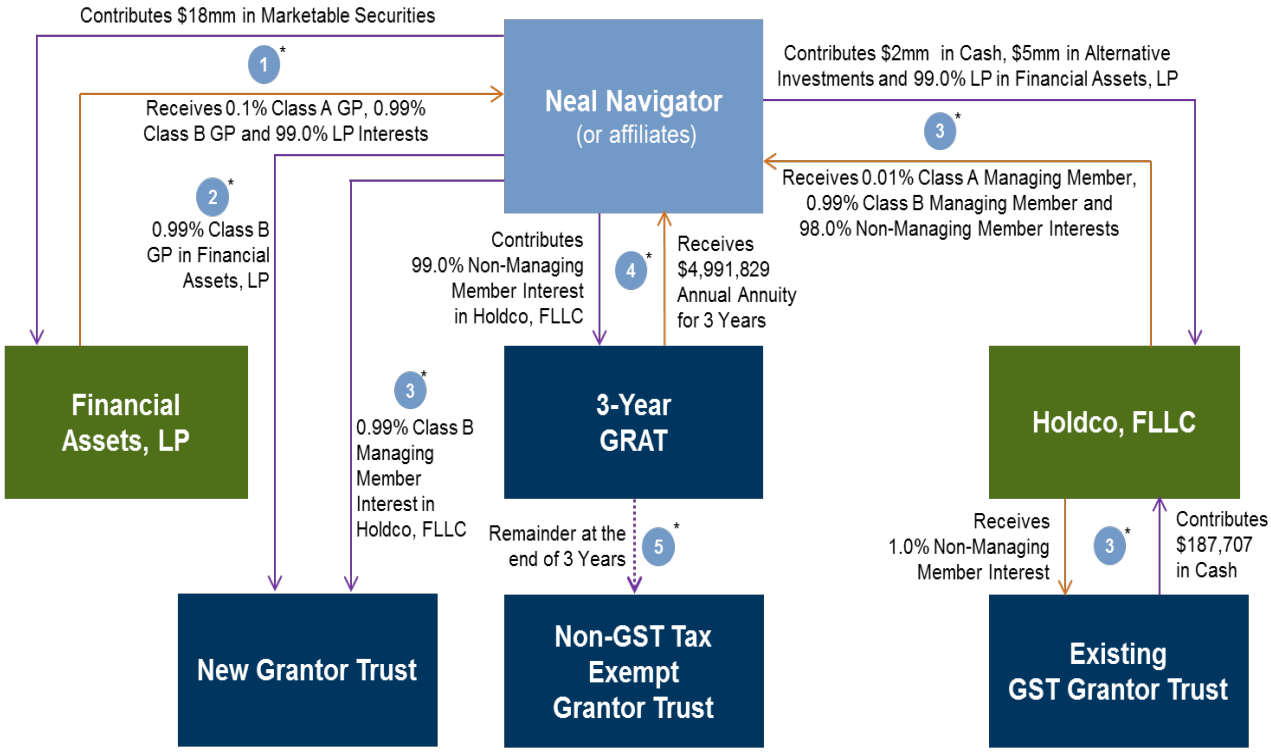
Lenny agrees to illustrate the differences in the two GRAT techniques and agrees to perform some calculations under the above assumptions assuming Neal's assets grow at 3.4%, 7.4% and 10% a year.

Lenny's proposed techniques, assuming the IRC Sec. 7520 rate is 2.2%, are illustrated below:

GRAT Technique A (Without the Use of Discounted Interests in Entities)



GRAT Technique B (With the Use of Discounted Interests in Entities)



*These transactions need to be separate, distinct and independent.

B. Income Tax and Basis Enhancing Advantages of a GRAT.

1. Ability of grantor to pay for income taxes associated with GRAT gift tax-free and substitute assets of the GRAT income tax-free.

A GRAT can be designed to be an effective trust for estate and gift tax purposes and income tax purposes (i.e., a so-called grantor trust). That is, the trust will not pay its own income taxes, rather the grantor of the trust will pay the income taxes associated with any taxable income earned by the trust. *See* discussion *supra* Section III.B.1.

Thus, if the assets of the GRAT, any time during the term of the GRAT, have significant appreciation, the grantor is in a position to substitute other assets to lock in the profit of the GRAT. As a practical matter, the ability to substitute assets may be used by the grantor of a GRAT to "lock in" appreciation in the investment of a GRAT prior to the end of the Annuity Period by substituting other assets of equal value that are less likely to fluctuate, if at the time of such substitution the yield or appreciation of the investments of a GRAT surpasses the Statutory Rate. In this connection, Treas. Reg. § 25.2702-3(b)(5) requires the governing instrument of a GRAT to prohibit additional contributions to the GRAT after its inception. It might be argued that the power to swap assets of equal value constitutes a power to make an additional contribution. However, to date the Service has not made this connection. In addition, numerous private letter rulings have approved GRATs containing a power of substitution without raising or

reserving as to this issue.[63] Other considerations with respect to swapping assets with respect to GRATs are addressed later in this paper.

2. A GRAT does not require the use of the unified credit and the unified credit can be saved to protect the estate cost of a taxpayer dying with low basis assets.

A GRAT can be designed to work without the use of the unified credit, thus, preserving its availability to use against the estate tax, which ameliorates the estate tax cost of retaining low basis assets in order to receive a step-up at death.

Currently, the highest marginal estate tax bracket is 40%. The highest marginal long-term capital gains tax bracket, taking into account the *Pease* limitation and IRC Sec. 1411, is 25%. Thus, any freeze strategy, such as the GRAT strategy, which does not use any unified credit, for a very wealthy client, even if the client only owns zero based assets, is superior to not freezing. The reason is rather simple. The marginal rate of 40% is higher than 25%.

3. A GRAT has all of the income tax and basis advantages of the SIDGT technique. *See* the discussion *supra* Section III.B.2.

C. Considerations of Using a GRAT.

1. Financial reasons why a GRAT may not succeed.

A famous University of Texas football coach, Darrell Royal, once explained why he disdained the forward pass, "Three things can happen when you throw a pass and two of them are bad." To a certain extent the same thing can be said about investments that are placed in a GRAT. If the investment goes down (the equivalent of a pass interception), or if an investment only increased modestly (the equivalent of a pass incompletion), the GRAT will be unsuccessful in transferring wealth to the remainderman. Thus, because of investment performance, many GRATs may not be successful.

a. Some assets are not volatile.

Generally, assets that have a chance to have a significant result over the Annuity Period have a wide variance of possible investment outcomes. A stable asset portfolio, while in another context generally desirable, is not a desirable portfolio for a GRAT. If the leading objective of the GRAT is to produce a transfer of wealth to the remainderman, variance of return (or risk) is a friend, not an enemy. Thus, the challenge for the practitioner for clients that have a stable portfolio of assets is how to make the GRAT an effective technique.

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[63] *See*, e.g., PLR 200220014 (Feb. 13, 2002); PLR 200030010 (Apr. 26, 2000); PLR 200001013 (idem, 200001015 (Sept. 30, 1999)); PLR 9519029 (Feb. 10, 1995); PLR 9451056 (Sept. 26, 1994); PLR 9352007 (Sept. 28, 1993); PLR 9352004 (Sept. 24, 1993); and PLR 9239015 (Jun. 25, 1992).

b. Some GRAT investments are only profitable if the investment is long.

Another challenge for the practitioner in dealing with many clients' normal asset portfolio is that the assets are only profitable if the markets in which the assets are invested increase. Markets do not always increase in value, nor do the assets which find much of their return related to that market always increase in value. Thus, if the markets are flat, or if the markets are decreasing in value, many of the GRATS created during that period will be unsuccessful.

2. If a GRAT is not administered properly, the retained interest by the grantor may not be deemed to be a qualified interest.

a. The *Atkinson* worry.

The U.S. Court of Appeals for the Eleventh Circuit (*see Atkinson v. Commissioner*, 309 F.3d 1290 (11th Cir. 2002), *cert denied*, 540 U.S. 945 (2003)),[64] has held that an inter vivos charitable remainder annuity trust's (CRAT's) failure to comply with the required annual payment regulations during the donor's lifetime resulted in complete loss of the charitable deduction. The Court found that the trust in question was not properly operated as a CRAT from its creation. Even though the subject CRAT prohibited the offending acts of administration, the Court held that the CRAT fails.[65]

In a similar fashion, the Internal Revenue Service could take the position that if the regulations under IRC Sec. 2702 are violated by the trustee of the GRAT's administrative practices, then the interest retained by the grantor will not be a qualified interest. Just as in the *Atkinson* case, it may not matter if appropriate savings language is in the document. As explored below, there are many areas in which the administration of a GRAT may fail, including the following: (i) not timely paying the annuity amount due to the grantor; (ii) inadvertently making more than one contribution to the GRAT; (iii) inadvertently engaging in an activity (i.e., paying the annuity with a hard to value asset) that would constitute an underpayment of the amount owed to the grantor, which would constitute a deemed contribution; and/or (iv) inadvertently engaging in an activity (i.e., paying the annuity with a hard to value asset) that would constitute an acceleration of the amounts owed to the grantor (a commutation).

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[64] *See* also CCA 200628028 (July 14, 2006), PLR 201714002 and PLR 201714003.

[65] *See* also PLR 201714002 and PLR 201714003 in which the IRS ruled that, based on *Atkinson*, *infra*, the subject trusts failed to operate exclusively as a charitable remainder trust from its creation and throughout its entire existence by virtue of failing to operate in accordance with the terms by making distributions in excess of the annual trust income to the non-charitable beneficiary of the trust.

b. The annuity amount must be paid annually.

An annuity amount payable based on the anniversary date of the creation of the trust must be paid no later than 105 days after the anniversary date. An annuity amount payable based on the taxable year of the trust may be paid after the close of the taxable year, provided that the payment is made no later than the date on which the trustee is required to file the federal income tax return of the trust for the taxable year (without regard to extensions).[66] Failure to pay the annuity amount within these time limits may jeopardize the retained interest by the grantor of the trust from being a qualified interest. If a retained interest in the GRAT is not a qualified interest, then it will have a value of zero for purposes of determining the gift tax associated with the grantor's contribution of assets to the trust.

See infra Sections VI.B and VII for structural techniques that eliminate this consideration.

c. Paying the grantor in satisfaction of his retained annuity interest with hard to value assets may disqualify his retained interest from being a qualified interest, if the assets are valued improperly.

In order to have a successful GRAT, it is obviously desirable to have an asset that has significant potential for appreciation. It is desirable from a volatility and potential growth standpoint to contribute, in many instances, a hard to value asset to the GRAT. Many of the asset classes that have that potential for appreciation (e.g., closely held partnership interests, stock in subchapter S corporations, real estate, hedge funds and other private equity investments) are very difficult to value accurately.

The problem with a GRAT that owns hard to value volatile assets (such as in Technique B) is that when it is time to pay the retained annuity amounts to the grantor, it is often difficult to value the asset that is being used to satisfy the annuity obligation. If the distributed asset is finally determined to have had too low a value when it is used to satisfy the annuity amount owed by the GRAT, it could be deemed to be an additional contribution by the annuitant to the GRAT, which is prohibited. *See* Treas. Reg. § 25.2702-3(b)(5). On the other hand, if it is finally determined that the hard to value asset that is distributed in satisfaction of the annuity payment to the grantor had too high a value, it could be determined by the IRS that such a payment is a commutation, which is also prohibited. *See* Treas. Reg. § 25.2702-3(d)(5). Thus, the trustee of the GRAT, which is frequently also the grantor, must be very careful, like Goldilocks, to make sure that the annuity payments are "just right". Using hard to value assets, to make the "just right" payments, may be highly problematic.

See infra Section VII for a structural technique that allows hard to value assets to be contributed to a GRAT, yet does not use those assets to pay the GRAT annuity.

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[66] *See* Treas. Reg. § 25.2702-3(b)(4).

d. The contribution of assets to the traditional GRAT structure must be made at the exact point of the creation of the GRAT.

As noted above, there cannot be any additional contributions to a GRAT. If an assignment to a GRAT is not effective at the same time of assignment of another asset to a GRAT is made, that could be finally determined to violate the prohibition against additional contributions to a GRAT. That additional contribution could cause the retained interest in the GRAT by the grantor to not be considered a qualified interest for purposes of IRC Sec. 2702.

See infra Section VI.A for structural techniques that should solve this consideration.

3. The retained annuity interest is valued using the valuation principles under IRC Sec. 7520, which is typically higher than interest on an intra-family note.

One of the disadvantages of a GRAT in comparison to sales to intentionally defective grantor trusts is that the qualified interest is valued under IRC Sec. 7520, which is inherently higher than the AFR that may be used for notes received for sales to intentionally defective grantor trusts.

See infra Section VII for a structural technique that ameliorates this consideration.

4. A successful GRAT could regress to the mean by the end of the term of the GRAT.

As noted above, one of the disadvantages of the GRAT is that it cannot be commuted. The GRAT must last its designated term and the only permissible beneficiary of the GRAT during the term of the GRAT is the holder of the annuity interest. Assume a grantor creates a three year GRAT with a volatile stock in which there has been a significant increase in value by the end of year two. If the stock then regresses to a lower price before the end of the third year of the GRAT, less value will pass to the remainderman beneficiaries of the GRAT, than would have been the case, if the GRAT could have been commuted in two years.

See infra Section VII for a structural technique that ameliorates this consideration.

5. The traditional GRAT structure may not satisfy a client's stewardship goals because the Investments of the GRAT may have been too successful.

Many clients, in developing their future stewardship goals for their assets, have a view that only a certain percentage of their assets should go to their descendants. If a GRAT is more successful than a grantor anticipated, the possibility exists that the stewardship balance the client wishes to maintain may be upset.

See infra Section VI.C for a structural technique that eliminates this consideration.

6. The GST tax exemption may be difficult to leverage through the use of a traditional GRAT structure.

It is difficult to leverage the GST exemption with a GRAT. It is generally thought that the generation-skipping tax exemption of the grantor may not be leveraged, like the gift tax exemption may be leveraged, through the use of a GRAT. This is because of the estate tax inclusion period ("ETIP") rule found in IRC Sec. 2642(f)(3), which provides as follows:

> Any period after the transfer described in paragraph (1) during which the value of the property involved in such transfer would be includible in the gross estate of the transferor under Chapter 11 if he died. The transferor's exemption for generation-skipping tax purposes cannot be allocated until after the ETIP period.

Since a grantor is the only beneficiary of a GRAT during the Annuity Period, if the grantor dies during that term a significant portion (usually all) of the assets of the GRAT will be included in the grantor's estate under IRC Sec. 2036. Only after the Annuity Period passes and it is clear that the property will not be included in the grantor's estate for estate tax purposes, may a grantor's GST exemption be allocated.

7. A traditional GRAT structure in which there is a gift element will not be successful in transferring assets if the grantor does not survive until the end of the term of the GRAT.

If a grantor does not survive the Annuity Period a significant portion or all of the assets of the GRAT will be included in the grantor's estate. The amount of corpus of the GRAT that will be included in the grantor's estate is that amount that is necessary to yield the annuity payment to the grantor without reducing or invading the principle of the GRAT. The annual annuity receivable divided by the Sec. 7520 interest rate equals the amount includable under IRC Sec. 2036. *See* Treas. Reg. § 20.2036-1(c)(2) and Treas. Reg. § 20.2036-1(c)(2)(iii), Example 2.

See infra Section VI.D for structural techniques that may eliminate or substantially ameliorate this consideration.

VI. POSSIBLE STRUCTURAL SOLUTIONS TO ADDRESS CERTAIN ADMINISTRATIVE AND CERTAIN STEWARDSHIP DISADVANTAGES OF A TRADITIONAL GRAT.

A. Structural Solutions to Prevent the Inadvertent Additional Contribution of Assets to a GRAT.

1. When creating the GRAT, the grantor may wish to consider a provision that prohibits any additional contributions to the GRAT and if any additional contribution is made, a new GRAT must be created specifically to hold that contribution.

2. The grantor of the GRAT may wish to consider initially making the trust revocable. Once all assignments to the trust have been completed, the grantor could amend the trust to make it an irrevocable GRAT.

B. Structural Solutions to Ensure That the Annuity Amount is Always Deemed to Be Paid on a Timely Basis.

The grantor of the GRAT may wish to consider a provision in the trust document that provides (pursuant to a formula) a portion of the trust that is equal to the annuity amount due to the grantor shall not be subject to the trust. If that portion remains in the hands of the trustee after the annuity payment date, the trustee shall hold such property only as a nominee, or as an agent, for the grantor. The grantor may also wish to consider a provision in the trust document that the portion of the trust estate that is being held in that agent capacity can be comingled with the trust assets and that the person also serving as trustee has full authority, as agent, to invest the property.

C. Structural Solutions to Limit the Amount That is Received By the Remainderman of the GRAT.

Generally, it is advantageous for the grantor to put as much as he or she can afford into a GRAT because that increases the likelihood of the remainderman beneficiaries receiving assets when the GRAT terminates. For instance, assume a client holds an interest in a closely held company. The client believes that within the next few years there could be a monetary event with respect to his stock in the company either through a public offering or a merger. However, assume the client's stewardship goal is that, by the time of his death, a certain dollar amount will pass to trusts for the benefit of his descendants with the rest of his estate passing to his favorite charitable causes. Under those circumstances, the more stock the client contributes to a GRAT, the greater the chance is that there will be sufficient assets as the end of the term of the GRAT to at least equal stewardship goal he has for his descendants. The inherent conflict with that strategy is that the more stock of the closely held company that he puts into the GRAT the greater the chance that the remainder amount will exceed the stewardship goal that he has for his descendants.

A structural solution for a donor with those stewardship goals is to put a cap on the amount left in the trust for the benefit of his descendants at the end of the annuity term. To the extent that the value of the assets of the GRAT on its termination exceeds that cap, there could be a provision that requires that excess to revert back to the donor. In that manner, the client could be encouraged to contribute most, if not all, of his stock in the closely held business to the GRAT, which helps ensure that the GRAT will be successful in reaching his stewardship goal for his descendants, without the disadvantage of harming his charitable stewardship goals.

D. Solutions to Reduce the Mortality Risk in GRATs.

1. The grantor could sell her retained annuity interest.

If the sale is made to a grantor trust or to a spouse, the sale will not have any income tax consequences. Although the transfer of a retained interest that would otherwise cause inclusion under IRC Sec. 2036 is presumptively subject to the three-year rule of IRC Sec. 2035(a), a sale for full and adequate consideration is exempt under IRC Sec. 2035(d). The IRS could characterize consideration equal to the remaining value of the annuity as not full and adequate for purposes of IRC Sec. 2035 under the doctrine of *United States v. Allen,* 293 F.2d 916 (10th Cir. 1961). Even if the sale is not for full and adequate consideration, if the grantor lives at least three years after the sale, IRC Sec. 2036 inclusion should be avoided.

2. The grantor could use a life insurance to hedge against an early grantor death.

See discussion *infra* Section VII.C.1.

3. The grantor could purchase the remainder interest in a profitable GRAT from the remainder beneficiaries.

If before the end of the term of the GRAT, the GRAT is very profitable and the grantor wishes to lock in the gain and the mortality risk of the grantor, the grantor could purchase the remainder interest. If the remainder beneficiary is a grantor trust there will not be any income tax consequences triggered by the purchase. The proceeds of the purchase will be removed from the grantor's estate. The IRS could characterize such a purchase as a commutation, as it did for QTIP trusts in Rev. Rul. 98-8, 1998-1 C.B. 541. However, the policy underlying that ruling (to avoid an "end run" around IRC Sec. 2519) does not apply to a GRAT. In order to preserve this opportunity the GRAT trust document must not contain traditional spendthrift clauses and must permit a transfer of interests in the GRAT.

4. The GRAT could be created by the grantor in consideration of full and adequate consideration.

If the remainder interest of a GRAT is not created by gift, but is created for full consideration, IRC Sec. 2036 should not apply to the GRAT assets, if the grantor dies before the end of the term of the trust.

5. In order to keep the GRAT annuity amount very low, the donor could use a combination of the following strategies: a member interest in a leveraged FLLC could be contributed to the GRAT and the donor could allocate part or all of his gift tax exemption to the GRAT and reduce the retained annuity.

If a grantor dies before the end of the term of the GRAT all that will be brought back into his estate is the annuity amount divided by the then IRC Sec. 7520 rate. If the annuity amount is small, very little may be brought back into the grantor's estate under IRC. Sec. 2036. *See* discussion *infra* Section VII.

VII. MARRYING THE BEST CHARACTERISTICS OF A LAIDGT WITH A GRAT: THE ADVANTAGES AND CONSIDERATIONS OF CONTRIBUTING AN INTEREST IN A LEVERAGED FLLC TO A GRAT (THE SO-CALLED "LAGRAT").

A. What is the LAGRAT technique?

All wealthy taxpayers should consider an estate freeze estate planning technique that does not use any of their unified credit, even those taxpayers who have low basis assets. In all states, the marginal transfer tax rate is higher than the marginal federal and state capital gains rate. Thus, removing future growth of a taxpayer's assets, while preserving the taxpayer's unified credit to be used at the taxpayer's death, always results in lower net transfer and capital gains taxes, even for zero basis assets that are not sold during the taxpayer's lifetime.

Perhaps the best freeze technique that does not have to use any of a taxpayer's unified credit is described below. In addition to preserving the unified credit in order to receive the maximum step up without estate taxes, varieties of the technique described below also have the potential of saving capital gains taxes beyond the estate freeze. *See infra* Section VII.B.2.

A taxpayer could create a single member FLLC by contributing and selling financial and private equity assets to that FLLC. If the taxpayer is the only owner of the FLLC there should not be any income taxes or gift taxes associated with the creation of the FLLC.[67] The taxpayer could then contribute some or all of the FLLC member interests to a GRAT. After the term of the GRAT, the remainder beneficiary could be a grantor trust that names the grantor's spouse as a beneficiary and gives that spouse a special power of appointment. The technique will sometimes be described below as a "Leveraged Asset GRAT" or as a "LAGRAT."

[67] For the proposition that there should not be any income taxes because the sale of assets to a single member FLLC is ignored for income tax purposes, *see* Treas. Reg. § 301.7701-3(b)(1)(ii). For the proposition that there should not be any gift taxes for a sale of assets for less than the value of the assets on creation of the leveraged single member FLLC, *see Estate of Albert Strangi v. Commissioner*, 115 T.C. 35 (2000).

Consider the following example:

Example 6: Contribution of a Leveraged FLLC Member Interest to a GRAT

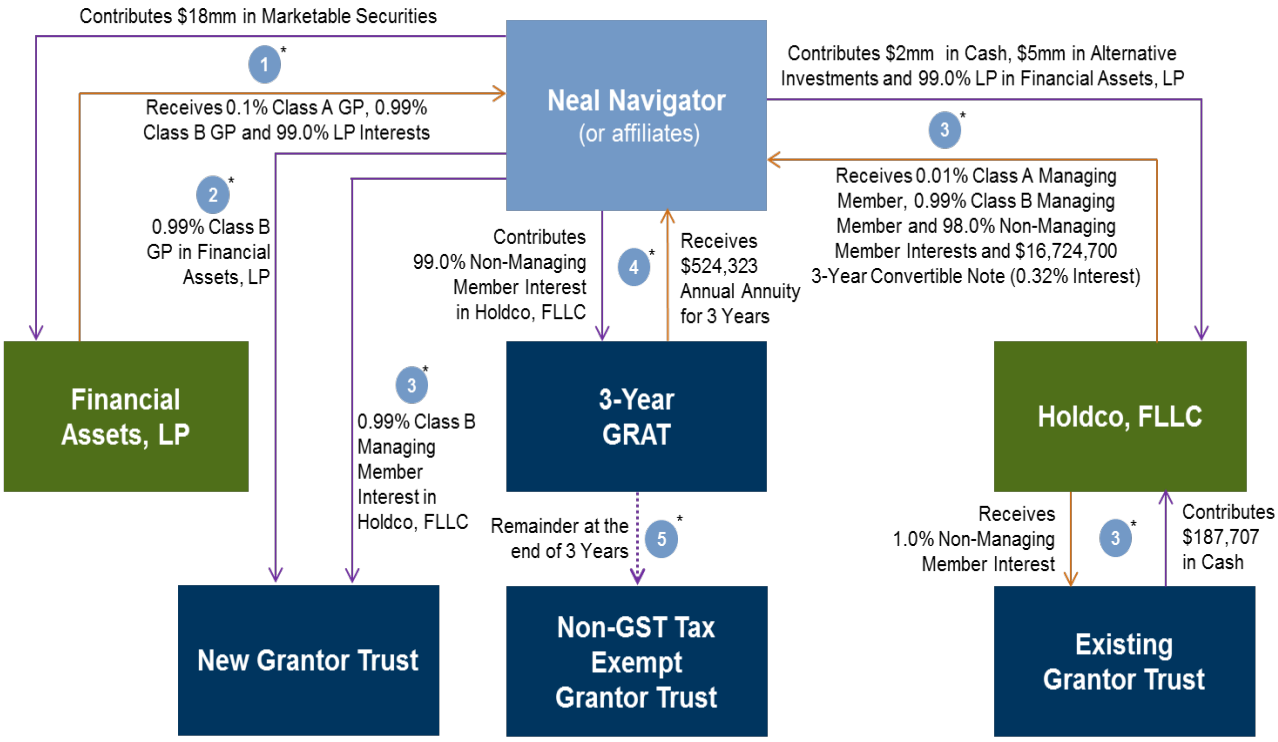
The facts are the same as Example 5, except Neal creates a leveraged Holdco. Lenny recommends that Neal contribute $18,000,000 of marketable securities to a FLP. Due to considerations with respect to retaining entity distribution, amendment and liquidation powers, Neal could retain the 0.01% Class A general partner interest and transfer the 0.99% Class B general partner interest. The Class A general partner interest would control all entity general partner decisions, including investment management decisions that are not delegated to the Class B general partner interest. The Class B general partner interests would control all distribution, amendment and liquidation decisions.

Neal could give his Class B general partner interest to a grantor trust in which the initial trustee is an advisor or family member he trusts. Neal could have the power to replace the trustee of that donee trust with a new trustee, as long as the replacement trustee is not related or subservient.

Lenny assumes Neal's limited partnership interest in FLP will have a 35% valuation discount. Neal would then transfer the 99% limited partnership interest in FLP, together with $5,000,000 of alternative investments and $2,000,000 cash, to a single member FLLC (or "Holdco") in a part sale/part contribution, receiving a convertible note equal to $16,724,700 (which is 90% of the assumed value of the assets transferred to Holdco). The note could be converted at any time, at the option of the holder to that number of Holdco, FLLC non-managing units that are equal in value to the then outstanding principal of the note. The note could have a mandatory conversion feature at the death of the holder of the note. Due to considerations with respect to retaining entity distribution, amendment and liquidation powers, Neal could retain the 0.01% Class A managing member interest and transfer the 0.99% Class B managing member interest. The Class A managing member interests would control all entity managing member decisions, including investment management decisions that are not delegated to the Class B managing member interest. The Class B managing member interests would control all distribution, amendment and liquidation decisions. Neal could give his Class B managing member interest to a grantor trust in which the initial trustee is an advisor or family member he trusts. Neal could have the power to replace the trustee of that donee trust with a new trustee, as long as the replacement trustee is not related or subservient.

Lenny assumes that Neal's non-managing member interest in Holdco will have a 20% valuation discount.

Lenny's proposed technique (Technique C below), assuming the IRC Sec. 7520 rate is 2.2%, is illustrated below:



*These transactions need to be separate, distinct and independent.

The technique described above is designed to join a discounted sale to a grantor trust to a near "zeroed out" GRAT so as to get the best of both worlds.

Instead of this transaction, Neal could create Holdco, FLLC without leverage and transfer his non-managing member interest in Holdco to a grantor trust for his spouse and descendants, taking back a note at the appropriate AFR with a principal amount equal to the discounted value of the transferred interest. In addition, cash or other assets with a value equal to 10% of the total transfer could be gifted to the trust. (Alternatively, the Holdco interest could be sold to the trust for 90% of its discounted value, with no additional gift.) The note could be structured so as not to require interest and principal payments in the near term of more than the trust's cash flow. The sale will not result in realization of gain because transactions between a grantor and a grantor trust are disregarded. *See* discussion *infra* Section VII.B.1. The underlying assets have a value in excess of the note equal to the "discount amount" resulting from the discounts for FLP and Holdco, which will be indirectly transferred to the Navigator family.

One aspect of the sale is the requirement that the purchasing trust have sufficient capital in excess of the amount of the note to justify treating the note as debt with a value equal to its face amount. A 10% cushion is widely believed to be the minimum adequate amount. In the technique, the discount amount would actually exceed the required cushion, but it is not clear that reliance on the underlying value that is not reflected in gift tax value would be regarded as sufficient, nor would this be good "optics." A bargain sale for 90% of value, or a separate gift, would create a 10% cushion, but each result in a taxable gift.

A key disadvantage of this approach is that the assets that are sold or given could be revalued. The IRS might argue for a lower discount in valuing the sold or given assets. A simple price adjustment clause that would increase the sale price to cover the increased value will not be recognized for gift tax purposes. A defined value transfer that shifts value in excess of the sale price to a marital or charitable disposition might succeed in avoiding a taxable gift but at the cost of diverting property away from the grantor trust, and while this has appellate case law support, there remains legal uncertainty about the success of the technique (the IRS has not acquiesced to the technique). A defined value transfer that reduces the quantum of property transferred to match the sale price has received some case law support, but cannot yet be called a proven technique (the IRS has not acquiesced to the technique), and it too would reduce the property passing to the grantor trust by keeping it with the grantor.

If the note were not treated as debt, because of too much leverage, or for some other reason, then it may be treated as a retained interest in the trust under equitable tax principles, potentially resulting in a taxable gift under IRC Sec. 2702 and inclusion under IRC Sec. 2036. *See* discussion *infra* Section VII.C.11. As we shall see, the LAGRAT finesses the debt issue (both as to adequacy of the cushion and as to the result of the note not being treated as debt under equitable principles) by making the sale to a single member FLLC prior to any transfer to the GRAT.

Alternatively, Neal could create Holdco, FLLC without leverage and contribute his non-managing member interest in Holdco to a GRAT. The discounted value of the transfer to the GRAT would be $14,717,736. For a three-year trust and an IRC Sec. 7520 rate of 2.2%, the annuity to zero out the transfer would be $5,123,310. The GRAT in theory solves the problem of getting the discounts generated by FLP and Holdco through the system without making an initial taxable gift. But will this be the case in the real world? The GRAT has no asset other than the Holdco interest. If "slices" of the Holdco interest are used to pay the annuity, the interests distributed must be valued using the valuation discount. Although the distributed slices of the Holdco interest must be valued at a discount, they carry with them the corresponding "full" value of the underlying assets, and nearly the entire Holdco interest must be distributed to satisfy the annuity. The discount amount does not pass to the donees (though some value may remain as a result of earnings on the discount amount). This problem would be solved if the GRAT could distribute cash in satisfaction of the annuity, but Holdco has only $2 million of cash, plus cash earnings during the GRAT term. Furthermore, the more cash that is distributed from Holdco, the lower the valuation discount will be; which in turn increases the amount of the GRAT annuity that must be paid.

Another approach would be for the GRAT to borrow the amount necessary to pay the annuity in cash from a third party. At the end of the GRAT term, the remainderman would receive the Holdco interest without diminution, and would assume the requirement to eventually repay the note. As long as the remainderman is a grantor trust, the assumption of the note should not be a realization event as to Neal or the GRAT. This approach in effect turns the GRAT into a LAGRAT. Borrowing from a third party results in interest on the loan passing outside the family. The "third party" could, however, be Neal's spouse or an existing family trust, although taxable interest income to the lender would result.

In summary, unlike the sale to a grantor trust, the contribution of an interest in a non-leveraged entity to a GRAT offers certain protection from an inadvertent taxable gift upon revaluation, but presents the problem of where to get the cash to pay the GRAT's immediate annuity obligation, a problem not present with the sale to a grantor trust, where payment of principal and (if need be) interest on the note can be deferred.

The simplest way to "marry" a discounted sale and a GRAT would be to sell assets that could be discounted to the GRAT. Under the facts of this example, the assets transferred to Holdco could instead be sold to the GRAT (itself a grantor trust) for a note with a principal amount equal to 90% of their value, or $16,724,700. The gross taxable gift is $1,858,300. The GRAT annuity would be based on this reduced value. Instead of an annuity of $5,123,310 as in the unleveraged GRAT discussed above, the annuity would be $646,883. The total annuity payments over three years would have a present value of $1,858,300. The annuity payments could be satisfied using the $2,000,000 cash transferred to the GRAT. Even if there were no cash transferred, a 4% annual cash distribution from the assets would be $743,320, almost enough to cover the annuity and a 0.32% note. The leverage reduces the annuity while protecting from gift tax assets of sufficient magnitude to generate cash sufficient to pay the reduced annuity (or a good portion of it). The annual annuity amount could be further reduced by lengthening the term of the GRAT, until it was covered by the assets' projected cash flow. Thus, even if the GRAT assets earned only at the 7520 rate, the discount amount would be protected and would pass to the grantor trust that is the GRAT remainderman. Of course, the interest and principal on the note must be paid, but that is a longer-term issue.

One problem with this simple marriage is that the same 10% of the transferred value is both the cushion for the note, and the amount subject to the GRAT annuity. It could be argued that because that 10% will be consumed by the GRAT annuity, there really is no cushion. That may lead to the finding that the note has more characteristics of a retained interest in the trust than a note. If the note is not treated as debt under equitable tax principles, then the note may represent an interest in the trust that is not a qualified annuity under IRC Sec. 2702, resulting in a taxable gift.[68] It could be argued that the discount amount itself provides a sufficient cushion for the note, but as noted above, it is uncertain whether one can rely for the cushion on value that does not "exist" in determining the value transferred. The only sure solution would be to have a 10% gift taxable component in the transfer that is not offset by the annuity, which Neal wants to avoid. Any such taxable gift would also increase proportionally if the discount were reduced on audit. Another problem with this technique is that if the sale price is inadequate the sale could be deemed to be a deemed contribution. This consideration may be eliminated if the sale is first to a revocable trust. The revocable trust could, at a later time, be amended and become an irrevocable GRAT.

[68] In itself, this might not disqualify the annuity as a "qualified interest," though the IRS would probably argue that one or another of the requirements of Treas. Reg. § 25.2702-3(d) had been violated.

Beyond the cushion issue, the simple marriage of a discounted sale and a GRAT has not been approved in any case or ruling and many practitioners would be reluctant to be the test case of such a novel format.

The LAGRAT technique seeks to avoid the problems of the simple marriage by making the sale of the assets to an intermediate entity, a FLLC with a 1% managing member interest and a 99% non-managing member interest, and then transferring the 99% non-managing member interest in FLLC to the GRAT.

A side benefit of using the intermediate entity FLLC in the above illustration is the additional discount provided by FLLC. The illustration assumes that FLLC would afford an additional discount of 20% on top of the 35% discount afforded by FLP, so that the marketable securities indirectly held in FLLC would have a cumulative discount of 48%. The extra discount affords a benefit but is not the primary reason for using the second entity.

The limited partnership interest in this example, together with the alternative interests and cash, are transferred to FLLC in exchange for a note with a principal amount equal to 90% of the value of the transferred assets. The bargain sale leaves a 10% cushion in support of the note. If the note's validity as debt is tested at the moment of this transfer, it passes the cushion test and presumably is valid debt.[69]

Even assuming under tax equitable principles part or all of the purported debt from the FLLC is considered equity in the FLLC for tax purposes, the consequences that determination may not be as disastrous as they would be for part or all of a note being considered a retained trust interest in a sale to a grantor trust. That equity interest belongs to Neal, but it is an interest in FLLC, not a direct retained interest in the GRAT. *The application of equitable tax principles to treat a retained note as FLLC equity will not be treated as an interest in a trust that is a non-qualified interest under IRC Sec. 2702.*

B. Income Tax and Basis Enhancing Advantages of the LAGRAT Technique.

1. This technique has all of the same income tax and basis enhancing advantages of the LAIDGT technique.

See infra Section IV.B.

2. The technique has all of the same income tax and basis enhancing advantages of the GRAT technique.

See infra Section V.B.

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[69] Of course, at the moment of sale nothing turns on whether the note is debt or an interest in FLLC, since Neal already owns all the interest in FLLC. Only on the subsequent transfer to the GRAT does it become important that the note be treated as debt to avoid a possible taxable gift and potential inclusion (but *see* the discussion below of the consequences of "flunking" the debt test).

C. Considerations of the Technique.

1. If the grantor does not survive the term of the GRAT, part or all of the net value of the leveraged FLLC interests owned by the GRAT and the then value of the outstanding note receivable from the FLLC could be taxable in the grantor's estate.

If the grantor does not survive the term of the GRAT, the IRS takes the position that IRC Sec. 2036 will include the assets of a GRAT in the grantor's estate equal to the lesser of the value of the assets in the GRAT, or the dollar amount of the retained annual annuity divided by the then IRC Sec. 7520 rate.[70] Under the facts of Example 6, if the IRC Sec. 7520 rate increases to 5% before the GRAT terminates, and if the grantor dies before the end of the term of the GRAT, the lesser of the net value of the GRAT or $10,246,240 ($512,321 ÷ 5%) will be included in the estate of the grantor (Neal Navigator). Assuming the assets earn 7.4% annually before taxes the net value of Holdco in three years will be $12,381,520, assuming valuation discounts will not be allowed. *See infra* Schedule 8. However, that amount is greater than $10,246,240. Thus, the maximum amount included under IRC Sec. 2036 under those facts, is $10,246.240. The then principal amount of the note is also included in the grantor's estate under IRC Sec. 2033.

There are a number of techniques to eliminate the IRC Sec. 2036 concern that a death by the grantor of the GRAT will include some or all of the GRAT assets in the grantor's estate. *See* discussion *supra* Section VI.D of this paper.

One of the techniques is for part of the liquidity that is directly or indirectly owned by the GRAT to be invested in life insurance instead of financial assets to hedge against Neal's early death. As noted above, if the IRC Sec. 7520 rate rises to 5% at the time of Neal's death, because of the formula under the IRC Sec. 2036 regulations, the maximum under the facts of Example 6 that will be included in Neal Navigator's estate because of the GRAT annuity is $10,246.620 ($512,321 ÷ 5%). Also, if Neal dies before the GRAT annuity ends, under IRC Sec. 2033 the value of Neal's note receivable and the 1% retained managing member interest will also be taxable in his estate. The estate taxes associated with the IRC Sec. 2036 and IRC Sec. 2033 inclusion with Neal's early death could be mitigated or "hedged," if either the Holdco FLLC or Financial Assets LP purchases life insurance with Neal being the insured. There is a long line of authority that life insurance owned by a partnership entity is only taxable in the insured's estate under IRC Sec. 2033, and is not included in the insured's estate under IRC Sec. 2042.[71]

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[70] *See* Treas. Reg. §§ 20.2036-1(c)(2)(i), 20.2036-1(c)(2)(iii), Ex 2.

[71] *See* Treas. Reg. § 20.2042-1(c)(2); *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), aff'd on another issue, 244 F.2d (4th Cir. 1957), cert denied, 355 U.S. 827 (1957), acq. in result, 1959-1 C.B. 4; Rev. Rul. 83-147, 1983-2 C.B. 158; *Watson v. Commissioner*, 36 T.C.M. (CCH) 1084 (1977); *Estate of Fuchs v. Commissioner*, 47 T.C. 199 (1966); *Estate of Infante v. Commissioner*, 29 T.C.M. (CCH) 903 (1970); *Estate of Tompkins v. Commissioner*, 13 T.C. 1054 (1949).

Under Example 6, assume Neal is 60 years old and Financial Assets, LP buys a combination of 10-year term life insurance and permanent life insurance to pay for the potential estate tax cost of Neal's passing within three years of creating the LAGRAT. Assuming the estate tax rate is 40%, Neal would need to purchase a maximum of $4,098,648 of term life insurance ($10,246,620 x 40%) to pay the estate taxes because of the IRC Sec. 2036 inclusion of the GRAT, and a maximum of $6,689,880 ($16,724,700 x 40%) of permanent life insurance to pay for the IRC Sec. 2033 inclusion of Neal's note receivable and the remaining 1% member interest in Holdco FLLC.

The cost of the ten year term life insurance premiums to hedge or pay for the potential IRC Sec. 2036 inclusion would be $10,893 each year. The annual cost of the $6,689,880 permanent life insurance policy to hedge or pay for the potential IRC Sec. 2033 inclusion would be $93,362 a year.[72] Thus for an annual outlay of $104,255, which is .417% of the assets subject to the LAGRAT in this example, Neal Navigator's early death estate tax problem is solved.

Under those facts, if Neal is then in the maximum estate tax bracket and has used all of his estate tax exemption, and has an early death, the synergy of the use of the LAGRAT and the use of life insurance is quite remarkable. The loss of the family's net worth is reduced from 40% to a little over 1%.

Obviously, after the GRAT annuity period ends the IRC Sec. 2036 exposure also ends and Neal could terminate the term life insurance and the associated premiums. Neal could also terminate or reduce the permanent life insurance premiums as his IRC Sec. 2033 estate tax exposure because the retained note is also reduced.

2. The LAGRAT is more complex to initially create than the traditional GRAT (but it is less complicated than using the alternative "freeze" technique of cascading GRATs that would be created each year).

While this technique solves considerations in paying GRAT annuities with hard to value assets and has the distinct advantage of substantially outperforming other GRAT techniques, it is more complex to initially create. However, after the termination of the GRAT, it should not be any more complex to administer than a sale of partnership interests to a grantor trust.

[72] Many thanks to Preston Sartelle of Capital Strategies Group, Inc. who used certain current assumptions of current TIAA-CREF life insurance products to give the author the above annual premium assumptions.

3. Care must be taken to make sure that there is not a violation of the treasury regulation that prohibits "issuance of a note, or other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount."

If there is an indirect issuance of a note in satisfaction of the retained GRAT annuity amounts, the annuity amounts will not be considered qualified annuity interests and the annuity amounts will be worth zero in determining the gift to the remainder trusts. *See* Treas. Reg. § 25.2202-3(b)(1). In the context of the examples of this outline, the gift would be the fair market value of the non-managing member interests that were transferred to the GRATs. That gift would be comparatively low, around 8% of the gross value of the assets of the FLLC (assuming a 20% valuation discount and 90% leverage with respect to the FLLC), but the indirect issuance of a note in satisfaction of the annuity amount should be avoided.

Borrowing from others to make annuity payments is not addressed in the regulations, but is expressly acknowledged as being acceptable in the preamble to the regulations, if the step transaction doctrine does not apply. A GRAT borrowing from the grantor for purposes other than making annuity payments, such as to enable the trust to make other investments (or allowing the entity the GRAT owns to make other investments like the Holdco, FLLC in this example), is not addressed and, therefore, should be viewed as permissible, subject to the "directly or indirectly" step transaction caveat. In the LAGRAT technique, it should be easy to trace the borrowing proceeds from a grantor to an investment by the GRAT, or some other use by the GRAT (e.g., paying expenses), other than making an annuity payment.[73]

All of the retained leverage by the grantor in the LAGRAT technique is associated with the creation of Holdco when the grantor contributes assets in exchange for a note from Holdco. The grantor in this technique never loans money to the GRAT for any purpose, including the purpose of providing liquidity so that the GRAT can pay the GRAT annuity with liquid assets.

4. Care must be taken to make sure that the IRS cannot successfully take the position that the creation of Holdco, FLLC should be ignored for gift tax purposes and that the retained notes are in reality retained trust interests in the GRAT that do no constitute a qualified annuity interest under IRC Sec. 2702.

Holdco, FLLC could be disregarded under two different theories: (i) a single member FLLC should be per se disregarded for both income tax purposes and transfer tax purposes and/or (ii) even if single member FLLC's should not be disregarded for transfer tax purposes on a per se basis, the step transaction doctrine applies to the facts of the transaction and the FLLC is disregarded for transfer tax purposes.

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[73] *See* the discussion by Ronald D. Aucutt in "Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts." The American Law Institute Continuing Legal Education Planning Techniques for Large Estates (Apr. 8-10, 2015).

The argument that the FLLC should not be ignored for gift tax purposes on a per se basis, or under the step transaction doctrine, is greatly strengthened if the FLLC is also partially owned by another disregarded entity (e.g., an existing grantor trust) before the donor contributes his part of the non-managing member interests in the FLLC to the GRAT(s).

Even though the single member FLLC is per se disregarded for income tax purposes (*see* Treas. Reg. § 301.7701-3(b)(1)(ii)), it is not disregarded for gift tax purposes. In *Pierre v. Commissioner*, 133 T.C. 24 (2009), the full Tax Court held that because transfer taxes follows state law property rights, interests in a single member FLLC were valued for gift tax purposes as FLLC interests and not, as the IRS argued, with reference to underlying asset values.[74] The IRS has not acquiesced in the decision.

As noted in the examples, care should be taken to make sure that the leveraged creation of FLLC is recognized as an independent transaction under the step transaction doctrine. In applying the step transaction doctrine, the IRS or court may not treat the various steps of the transfer as independent. Instead, the steps may be collapsed into a single transaction.[75] Under the circumstances of the gift of a non-managing member interest in a leveraged FLLC to a GRAT, the crucial key to not run afoul of the step transaction doctrine may be establishing that the creation of the FLLC should stand on its own, especially if there is another owner of the FLLC as in the above example. Could the act of a transferor creating the leveraged FLLC be independently separated from the gift to the GRAT? The creation of the FLLC should be designed to be sufficiently independent on its own and as an act that does not require a gift to the GRAT. There does not have to be a non-tax purpose for the creation of and gift to the GRAT. It is difficult for this writer to understand the non-tax purpose of any gift.

The Supreme Court has said on two separate occasions that estate and gift tax law should be applied in a manner that follows a state property law analysis.[76] Thus, the key questions could be, is the creation of the FLLC with leverage recognized for state property law purposes, and is its creation independent of any other events, including the subsequent gift to the GRAT? Stated differently, for state law property purposes, would the creation of the FLLC be recognized independent of the gift to the GRAT? It would seem to this writer that in many situations it could be demonstrated that the creation of the FLLC did not require a gift to the GRAT for state law property purposes or for tax purposes. Furthermore, creating a FLLC with debt has economic risk to the current owners and future owners of the FLLC. The creation of the FLLC has both risk and reward. The value of the FLLC assets could depreciate below the value of the note. Depending upon the size of the transaction, 10% equity may represent real risk in comparison to the reward of the leverage. One percent equity may not.

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[74] A subsequent memorandum decision, T.C. Memo 2010-106, applied the step transaction doctrine to collapse certain sale and gift transfers of 9.5% and 40.5% into single 50% transfers.

[75] *See* Donald P. DiCarlo, Jr., "What Estate Planners Need to Know About the Step Transaction Doctrine," 45 Real Prop. Tr. & Est. L.J. 355 (Summer 2010).

[76] *See United States v. Bess*, 357 U.S. 51 (1958); *Morgan v. Commissioner*, 309 U.S. 78 (1940).

An excellent discussion of the interrelationship of creating a FLLC, transferring a member interest in a FLLC, state property law, federal transfer tax law and the step transaction doctrine is found in the *Linton*[77] case.

If the creation of the FLLC is ignored for gift tax purposes, then under equitable tax principles the sale and contribution of the underlying assets of the FLLC is to the GRAT instead of to the FLLC. The value of the GRAT will increase. Assuming the valuation discount for the transferred non-managing member interests is 20%, then ignoring the valuation discounts will increase the value of the GRAT by 20% and the GRAT annuity amounts will increase by 20%.

If the creation of the FLLC is ignored for gift tax purposes, does it matter what the terms of a trust are in determining if the cushion is adequate on a sale to a trust in order to have a note recognized as a note instead of as a retained interest in the trust? It may matter. On its face, there may be plenty of cushion on the sale and the note would be recognized as a note. However, the terms of this trust, after payment of trust obligations, are that all of the net assets are to be distributed to the grantor of the trust (who is also the owner of the note) unless there is growth of the assets. Does the fact that the GRAT is in effect a short term trust in which most of its assets are to be distributed to the grantor, after payment of the outstanding note to the grantor, equitably convert the note to a retained interest in the trust? If the note is treated as a retained interest in trust, the terms of the note may not comply with the definition of a qualified payment under IRC Sec. 2702 and the gift will be all of the assets of the GRAT minus the annuity payments that do qualify.

5. Care must be taken if the underlying asset that is sold or contributed to the single member FLLC is stock in a subchapter S corporation.

Assuming the FLLC is a single member FLLC and/or is owned by other disregarded entities for income tax purposes, the FLLC may own subchapter S stock.[78] If the FLLC is not a single member FLLC, it will not be a permissible shareholder of a subchapter S corporation and the subchapter S election will be terminated. The FLLC should be drafted to make it clear that it dissolves and liquidates upon the earlier of a term of years or the death of the single member owner. If the FLLC terminates and dissolves on the single member's death, the subchapter S election may be preserved.[79]

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[77] *See Linton v. United States*, 630 F.3d 1211 (9th Cir. 2011); *see also* the following cases which also held that the step transaction doctrine did not apply under the facts of the case: *Holman v. Commissioner*, 601 F.3d 763 (8th Cir. 2010); *Senda v. Commissioner*, 433 F.3d 1044 (8th Cir. 2006); *Gross v. Commissioner*, T.C. Memo 2010-176 (2010). *But see Heckerman v. United States*, 104 A.F.T.R. 2d 5551 (W.D. Wash. 2009), which held the step transaction doctrine did apply.

[78] *See* PLRs 9739014, 9745017, 200107025 and 20008015. These private letter rulings do not consider whether an FLLC having a grantor and grantor trust as members will be considered to have only one owner and therefore remain a disregarded entity, but they support that result.

[79] *See* PLR 200841007. In this private letter ruling the deemed single member LLC was owned by five separate grantor trusts when the grantor died. One day after the grantor's death, the LLC was liquidated and distributed its subchapter S stock to the new five non-grantor trusts. The representative of the grantor represented

VIII. VARIOUS TECHNIQUES TO ENHANCE THE BASIS OF ASSETS HELD IN AN INCOME TAX DISREGARDED ENTITY.

A. Substituting a Grantor's High Basis Assets for the Income Tax Disregarded Entity's Low Basis Assets.

If there are low basis assets inside a grantor trust, or a disregarded single member FLLC, the grantor could substitute high basis assets for the low basis assets held by the grantor trust or the disregarded single member FLLC.

1. Advantages of the technique.

   a. The low basis assets, if retained by the grantor, will receive a basis step-up on the grantor's death.

   b. If the low basis assets are sold by the grantor before his or her death the cost of the capital gains taxes will be borne by the grantor (just as they would have been if the assets had been sold by the grantor trust or a disregarded single member FLLC.)

2. Considerations of the technique.

   a. The grantor may not have any high basis assets, or cash, to swap.

If that is the case, consider a recourse third party loan of cash to the grantor from a third party lender. The grantor could then use that cash to swap for the low basis asset. The grantor trust may then be converted to a complex non-grantor trust. At a later time, in an independent transaction, the grantor could borrow the high basis cash from the trust with a long-term, recourse note that is unsecured and use that cash to pay the principal of the third party loan. This lending strategy is described *infra* Section VIII.B.

   b. To the extent, after the swap of assets, "swapped" low basis assets grow more than the "swapped" high basis assets in the grantor trust, the grantor's estate taxes will increase.

That consideration could be mitigated by a reverse note purchase technique described above. For instance, assume that a grantor wishes to borrow cash from the trust. That loan could be accomplished by a recourse, unsecured note that pays a fair market value interest rate. That interest rate carry may be higher than the rate of return of the high basis asset, which would mitigate or eliminate any estate tax cost associated with the low basis asset's growth in the grantor's estate.

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that the existence of the new partnership for one day after the grantor's death was inadvertent and was not motivated by tax purposes. The IRS agreed that the LLC was deemed to terminate on the day of the grantor's death and the subchapter S election remained in effect.

B. There is an Inherent Flexibility to Enter Into Basis Enhancing Strategies With the LAIDGT and the LAGRAT Techniques.

The use of this technique freezes the taxpayer's assets on a discounted basis. In other words, the appreciation of the assets, similar to a sale of a discounted asset to a grantor trust, is not subject to the taxpayer's future estate taxes. Unlike a sale to a grantor trust that is created by substantial use of a taxpayer's available unified credit, the technique does not require the use of the taxpayer's unified credit. Any unified credit that can be saved by using this technique may be used by the taxpayer to save estate taxes and capital gains taxes on the low basis assets owned by the taxpayer at his death. Thus, this may be an ideal technique for a taxpayer who wishes to preserve his unified credit to save estate taxes and capital gains taxes on certain low basis assets he may own at the time of his death.

The principal and interest of the retained note may be paid with either cash or in kind. There will not be any income tax consequences with in kind payments, if the FLLC remains a disregarded entity. If low basis assets owned by the FLLC are used to make some of those in kind payments, and if those low basis assets are retained by the grantor until the grantor's death, there will be a step-up in basis of those assets on the grantor's death under IRC Sec. 1014.

The creator of the FLLC, as long as it is a disregarded entity, could swap his individually owned high basis assets with the FLLC's low basis assets. The creator of the FLLC could also buy the low basis assets from the FLLC for a note. However, if the note is paid back after the creator's death there may be capital gains consequences to the then owners of the FLLC. The FLLC's basis in the note may be equal to the basis of the low basis assets that are purchased.

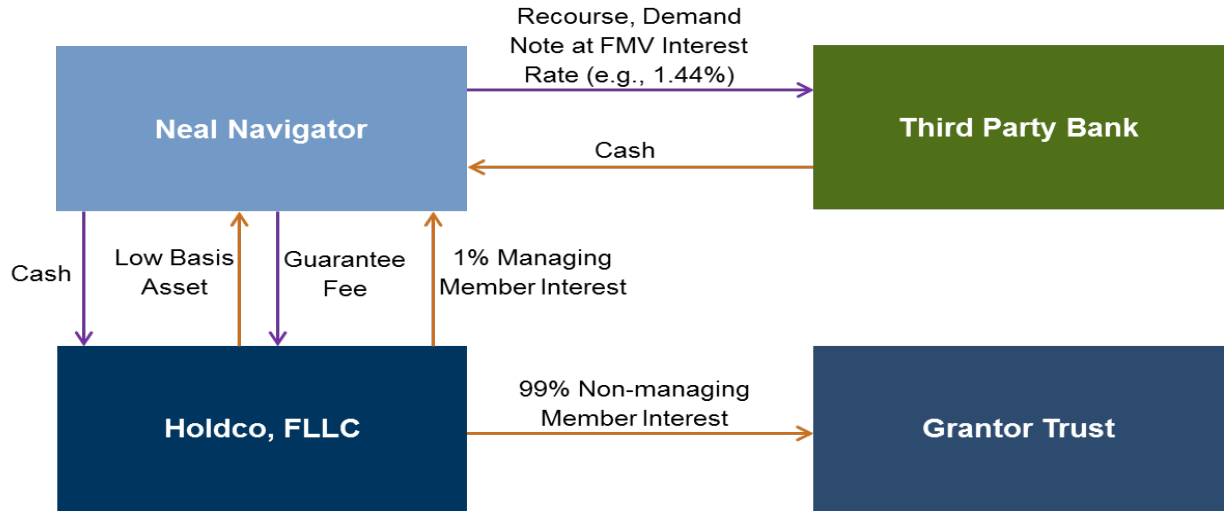
A better course of action for the creator of the FLLC who does not have any high basis assets, may be to borrow cash from a third party lender to make that exchange. At a later time the creator could refinance the note to the third party lender by borrowing cash from the FLLC. Generally, Neal's estate taxes will not increase with this basis enhancing technique because the acquisition of low basis assets, which will be taxable in Neal's estate, are offset by the note owed either to third party lender or, at a later time, to the FLLC.

Consider the following illustrated example:

Hypothetical Transaction 1:

Neal Navigator borrows cash from Third Party Bank and uses that cash to purchase low basis assets from Holdco FLLC, which is 99% owned by a grantor trust. Neal will be personally liable on the bank loan. Holdco FLLC could guarantee the bank's loan to Neal.

Hypothetical Transaction 1 is illustrated below:



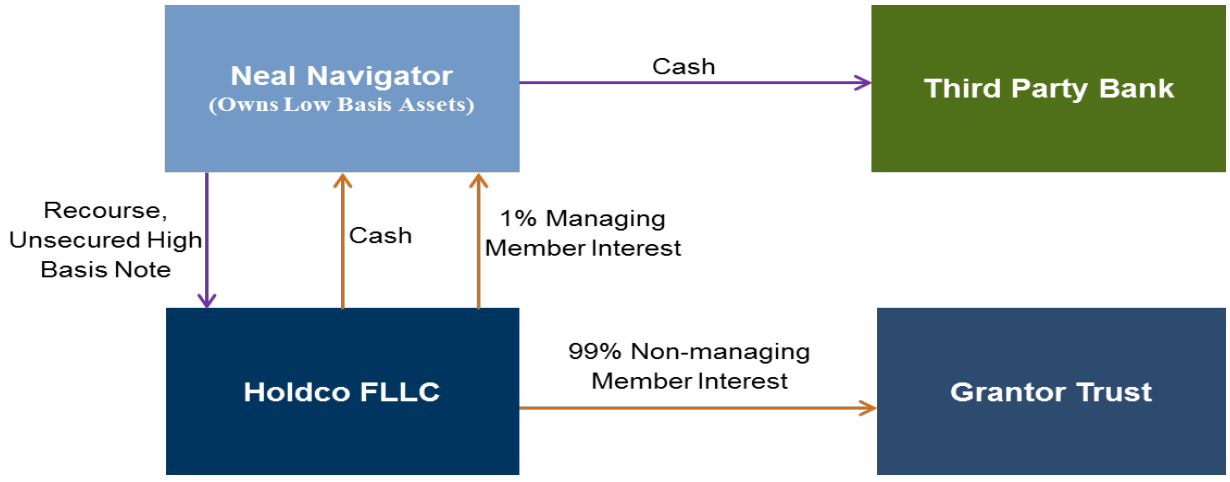
Hypothetical Transaction 2:

Neal Navigator could continue to borrow from Third Party Bank. Or, in a few years, because he would like the flexibility of a recourse, unsecured long-term note, or because interest rates have moved, or because of some other financial reason, he could borrow cash from Holdco FLLC to extinguish the Third Party Bank note.

The recourse, unsecured long-term note with Holdco FLLC will be at a fair market interest rate that is much higher than the AFR. Neal will be personally liable on the note owed to Holdco FLLC.

Holdco FLLC's basis in the new recourse, unsecured note may be equal to the cash that is loaned.

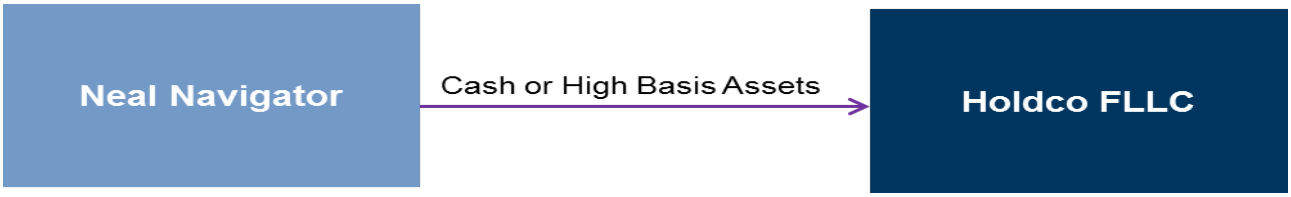
Hypothetical Transaction 2 is illustrated below:



Hypothetical Transaction 3:

Upon the death of Neal Navigator, the estate satisfies the note to Holdco FLLC with the now high basis assets or cash (if the high basis assets are sold after the death of Neal Navigator).

Hypothetical Transaction 3 is illustrated below:



IX. USING A COMBINATION OF DISREGARDED INCOME TAX ENTITIES AND THIRD PARTY CREATED TRUSTS IN WHICH THE TAXPAYER IS A BENEFICIARY.

A. The Advantages and Considerations of a Transferor Selling Assets to a Trust That Names the Transferor as a Beneficiary, Gives the Transferor a Special Power of Appointment, and Under Which the Transferor's Spouse is Considered the Income Tax Owner ("Spousal Grantor Trust").

1. What is the technique?

Beneficiary sales to a Spousal Grantor Trust may constitute effective estate planning. It is an attractive estate planning technique because it has the advantages of the SIDGT technique with the additional advantages that the selling taxpayer is also a beneficiary of the trust.

Consider the following example:

Example 7: Ann and Aaron Appointment Wish to Make
Transfers of Their FLP Interests and Maintain Maximum Flexibility

Ann and Aaron Appointment approach their attorney, Ray Reciprocal, and tell him they would like to transfer their FLP interests in a manner that maintains maximum future flexibility and ensures that there will be no gift tax surprises.

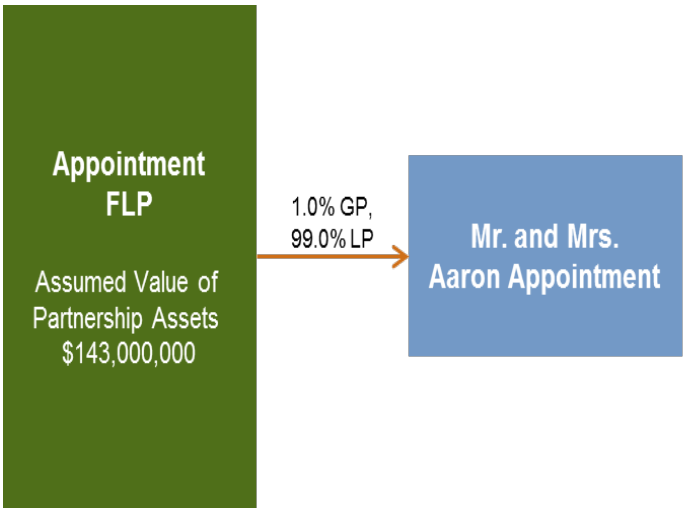
Ray suggests they consider creating trusts for each other as discretionary beneficiaries (with different provisions) that will not be considered reciprocal trusts and under which one spouse would have a lifetime special power of appointment and the other spouse would have a testamentary power of appointment (also with different provisions). The trusts will be grantor trusts to the spouse who creates the trust.

Ann has a 5% limited partnership interest in the FLP, which has a value of $5,000,000 after considering valuation discounts. It is assumed the valuation discounts for the transfers is equal to 30%. Aaron has a 94% limited partnership interest that has a value of $94,000,000 after considering valuation discounts. Ann creates a grantor trust for the benefit of Aaron and her family by gifts of her partnership interest (GST Grantor Trust 1) pursuant to a defined value

formula assignment. Aaron creates a trust for the benefit of Ann and their family by contributing a 5% limited partnership interest (GST Grantor Trust 2) pursuant to a defined value formula assignment.

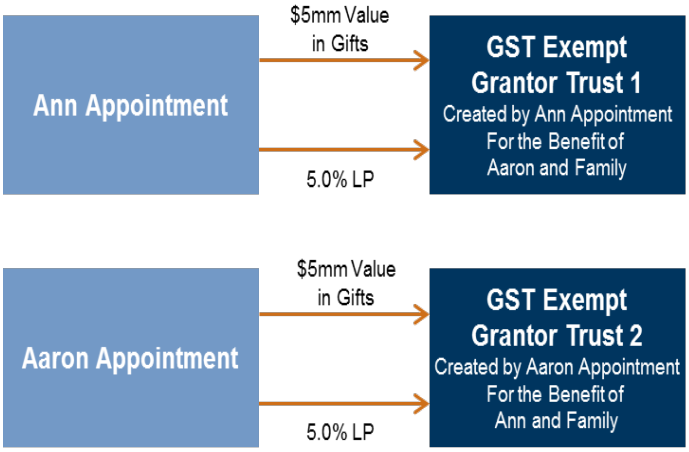
Ray suggests that after the trusts are created that Aaron sell 44.5% of his limited partnership interests to the trust Aaron created for Ann's benefit (GST Grantor Trust 2) pursuant to a defined value formula assignment and Aaron sell his remaining 44.5% limited partnership interest to the trust Ann created for his benefit (GST Grantor Trust 1). Nine-year notes are used. It is assumed the AFR for a nine-year note is 0.87%.

The ownership of the FLP is illustrated below:



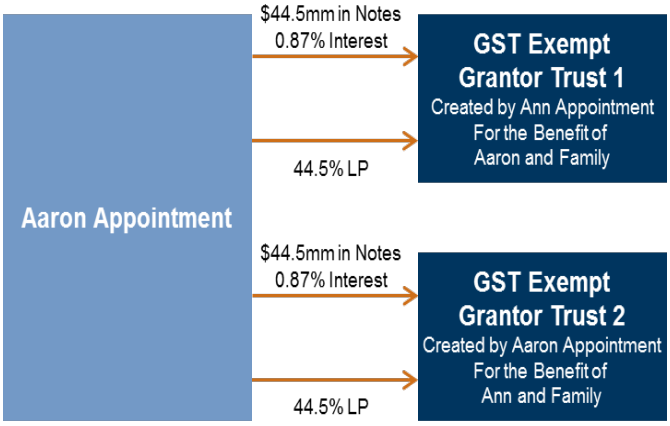
Partner	Ownership %
Aaron Appointment (or affiliates)	1.0% GP, 94.0% LP
Ann Appointment	5.0% LP

The proposed gift to create the proposed trusts is illustrated below:



Partner	Ownership %
Aaron Appointment (or affiliates)	1.0% GP, 89.0% LP
GST Exempt Grantor Trust 1 Created by Ann Appointment	5.0% LP
GST Exempt Grantor Trust 2 Created by Aaron Appointment	5.0% LP

The proposed sale of the remaining 89% limited partnership interests by Aaron is illustrated below:



Partner	Ownership %
Aaron Appointment (or affiliates)	1.0% GP, 89.0% LP $89,000,000 Notes Receivable
GST Exempt Grantor Trust 1 Created by Ann Appointment	49.5% LP $45,500,000 Note Payable
GST Exempt Grantor Trust 2 Created by Aaron Appointment	49.5% LP 45,500,000 Note Payable

2. Income tax advantages of the technique.

a. There will be no capital gains consequence on the original sale of the assets to the trust.

A sale to a Spousal Grantor Trust should not be recognized for income tax purposes because of IRC Secs. 1041 and 671. As noted above, under Rev. Rul. 85-13, a grantor trust is deemed to have no existence with respect to transactions between the grantor and the trust. To say that transactions between the grantor and the trust are treated as transactions between the grantor and himself is not quite the same as saying that transactions between a third party and the trust are treated as transactions between the third party and the grantor. The latter conclusion, however, follows logically from the former, and this extension of Rev. Rul. 85-13 has been endorsed by two private rulings. PLR 8644012 and PLR 200120007 hold that a transfer between H (or H's grantor trust) and W's grantor trust is treated the same way as a transfer between H and W and is governed by IRC Sec. 1041. Therefore, there should be no capital gains tax consequences to the transactions explored above.[80]

However, interest on notes issued as consideration for a sale to a spousal grantor trust will be recognized for income tax purposes, because IRC Sec. 1041 does not prevent inter-spousal interest from being taxable. Generally, the interest will produce an offsetting deduction and income to the spouses. The principal and income of the notes can be paid with cash flow that is naturally distributed to the partners in order to pay their income taxes.

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[80] *Rothstein v. United States.*, 735 F.2d 704 (2nd Cir. 1984), held that a transaction between a grantor trust and a grantor was not disregarded for income tax purposes. This case has not been overruled and stands as authority of a high level against the income tax analysis herein. However, the IRS disagreed with the case in Rev. Rul. 85-13 and, it appears, has never departed from Rev. Rul. 85-13 or relied on the case even when to do so would have favored the government. As a practical matter, until the IRS reverses its holding in Rev. Rul. 85-13, it seems that Rothstein may be ignored. *See also* the discussion *supra* Section IV.B.3.

b. By using basis enhancing techniques the basis of the taxpayer's assets may be increased.

See supra Sections IV.B and VIII.

c. The technique has the asset class location advantage of the SIDGT technique.

See supra Section III.B.2.

3. Considerations of the technique.

a. Federal income tax considerations.

As noted above, the sale to a Spousal Grantor Trust should be income tax free. However, the seller will be taxed on the interest on the note. As long as the seller spouse is living, he or she should receive a corresponding deduction on the interest on the note. Thus, assuming the spouses file joint returns, the interest income and the interest deduction should be a "wash" in most circumstances.

b. State income tax considerations.

See discussion *supra* Section III.C.2.

c. Necessary to file gift tax returns.

In order to get the gift tax statute of limitations running, it is advisable to file a gift tax return even if the grantor/seller to the Spousal Grantor Trust is reasonably confident that the sale is for adequate and full consideration. If the gift tax return is accepted there should not be any gift tax consequences[81] and arguably there should not be any further open issue with respect to IRC Sec. 2036, even if the grantor/seller is a beneficiary of the trust.[82] However, if the Service successfully takes the position that the sale is not for adequate and full consideration, the seller will be considered a grantor of a portion of the trust. For IRC Sec. 2036 purposes, not only the portion of the trust in which the grantor has made a gift will be brought back into the grantor's estate, but that portion associated with the note may be brought back into the grantor's estate. There will be a consideration offset for the note allowed under IRC Sec. 2043, but that is generally inadequate if there has been appreciation in the assets of the trust. Thus, it is very advantageous to find out what portion of the trust the grantor/seller is considered a grantor by filing a gift tax return. As noted above, it may be possible to do further planning to ameliorate the IRC Sec. 2036 concerns by splitting the trust into a portion the seller is considered a grantor of and a portion in which the spouse is considered a grantor.

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[81] *See* IRC Sec. 2504(c).

[82] *See* IRC Sec. 2001(b); Treas. Reg. Section 20.2001-1(b). See, however, the final paragraph of the discussion *supra* Section XI.D.3.b.(4).

d. Reciprocal trust doctrine considerations.

The common law reciprocal trust doctrine could be applied by the IRS and or the courts in the creation of mutual spousal grantor trusts. Perhaps one of the cleaner ways to lessen concerns about the application of that doctrine is if only one spouse is the seller to each trust, created by the spouses. Particularly, if the sales are done for different considerations and using different trust techniques (*e.g.*, one sale involves the sale to a spousal grantor trust and the other transaction involves the contribution of leveraged FLLC interests to a GRAT).

e. If it is possible for a current creditor, or any future creditor, of the assigning beneficiary to reach part of the assets of the trust for a period of time that does not end before the assigning beneficiary's death, by either voluntary or involuntary assignment by the assigning beneficiary, then that part of the trust may be included in the assigning beneficiary's estate under IRC Secs. 2036 or 2038.

Even if an assigning beneficiary does not have any current creditors, or any future creditors, if the assigning beneficiary *could* create a creditor relationship under which part of the trust assets, either under state law or federal bankruptcy law, would be available to satisfy the creditor obligation, that part of the trust will be included in the assigning beneficiary's estate for estate tax purposes. Even if the sale is for adequate and full consideration for gift tax purposes the IRS could take the position that either (i) the sale is not adequate for creditor protection purposes under the relevant state property law or (ii) even if the sale is adequate for state law purposes, the assigning beneficiary, under certain assumptions, could still create a future creditor relationship that could access the trust.

The sale must be for adequate and full consideration, not only for gift tax purposes, but also for state law creditor protection purposes. There is more pressure on a sale to a trust in which the seller is also a beneficiary of the trust. Generally speaking, under the law of most states, an assigning beneficiary's creditor can reach the maximum amount that can be distributed by a trustee to the assigning beneficiary, if there is an assignment by the assigning beneficiary for less than full consideration under state property law.[83] In other words, under the laws of most states, a grantor of a trust cannot create a trust and achieve creditor protection to the extent the grantor could be a beneficiary of that trust. It is the IRS's view, which has had some success in the courts, that a retained "string" exists under IRC Sec. 2036 or 2038, if the settlor of the trust has the capacity of creating such a creditor.[84] It does not matter at the time of death that such a creditor exists – it only matters that the creditor could exist because of the assigning beneficiary's actions. As noted above, if IRC Sec. 2036 or 2038 apply, all of the appreciation in

[83] E.g., *Vanderbilt Creditor Corp. v. Chase Manhattan Bank*, N.A., 473 N.Y.S. 2d 242 (App. Div. 1984); comment f to Restatement (3d) of Trusts § 60.

[84] Rev. Rul. 76-103, 1976-1 CB 293; Rev. Rul. 77-378, 1977-2 CB 348; *Estate of Paxton v. Commissioner*, 86 TC 785 (1986) and cases cited therein; *Outwin v. Commissioner*, 76 TC 153 (1981), acq. 1981-2 CB 1; *Paolozzi v. Commissioner*, 23 TC 182 (1954), acq. 1962-1 CB 4.

the trust after the sale may also be included because of the manner in which the consideration offset is applied under IRC Sec. 2043. Thus, it is important that the sale be for adequate and full consideration for state law creditor protection purposes, in order to avoid grantor status for the assigning beneficiary, which also affects the estate tax consequences of the transaction.

Sixteen states have adopted varying ways in which a grantor can create a self-settled trust, with an independent trustee, and also be a discretionary beneficiary of that trust, and the grantor's future creditors cannot reach the beneficial interest in the trust. What if the assigning beneficiary does not live in one of those states, but creates a trust subject to the law of one of those states that allow self-settled trusts? The IRS may take the position that even though the trust is subject to the self-settled state's laws, because of operation of the assigning beneficiary's state law (assuming the assigning beneficiary lives in a state that does not allow self-settled trusts), the assigning beneficiary could create a creditor relationship that would allow the creditor access to trust assets, which indirectly allows an assigning beneficiary to retain the ownership for estate tax purposes. The IRS may take the position that the assigning beneficiary could, at any time, create a significant debt and enjoy the benefit of the proceeds of that debt. That creditor, if not paid, could get a judgment against the assigning beneficiary. The IRS could take the position that any such judgment is enforceable against both the assigning beneficiary and the part of the trust the assigning beneficiary creates, even if under the state law governing the trust that judgment would not be enforceable. The IRS may take the position that creation of the trust would be against public policy of the domicile state of the assigning beneficiary. The IRS could argue that either because of comity, full faith and credit clause under the Constitution[85] and/or conflict of law rules,[86] the trust jurisdiction state would allow that potential creditor access to the trust. It would not matter to the IRS, for purposes of IRC Sec. 2036(a)(1), that the creditor never exists. The fact that the assigning beneficiary *could* create that relationship gives the assigning beneficiary a retained power to access the trust anytime and at the moment of death. There is not any definitive case law with respect to state property law creditor aspects of the above analysis nor the federal tax law aspects of the above analysis.

The IRS may also take the position that the assigning beneficiary of a trust subject to the laws of a self-settled state *could* create a creditor relationship, even if the assigning beneficiary is domiciled in that self-settled state, if there is a sale that constitutes inadequate consideration for state law property purposes, or because of federal bankruptcy laws. If the assigning beneficiary creates a self-settled trust, within 10 years of his death, the IRS could argue that the assigning beneficiary could have filed a bankruptcy petition under Chapter 7 within 10 years of his death, and the bankruptcy trustee could avoid the transfer to the self-settled trust and bring the trust

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[85] "Full faith and credit shall be given in each state to the public acts, records and judicial proceedings of every other state." (U.S. Const. Art IV, § 1). See also *Tennessee Coal, Iron & R.R. Co. v. George*, 233 U.S. 354, 360 (1914) and *Toni 1 Trust v. Wacker*, 2018 WL 1125033 (Alaska, Mar. 2, 2018).

[86] *See* comment d to § 145 of the Second Restatement of the Conflict of Laws, which states:

> [S]ubject only to rare exceptions, the local law of the state where conduct and injury occurred will be applied to determine whether the actor satisfied minimum standards of acceptable conduct and whether the interest affected by the actor's conduct was entitled to legal protection.

assets back into the bankruptcy estate for the benefit of creditors, because of 11 U.S.C. § 548(e). See the bankruptcy court decision in the *Battley v. Mortensen*, No. A09-90036-DMD (D. Alaska 5/26/11) holding that creditors of an Alaskan resident, whose claims arose after a validly created Alaskan self-settled trust, within 10 years of the transfer to the trust, could be satisfied in bankruptcy from the self-settled trust. On the other hand, 11 U.S.C. § 548(e) does not confer upon creditors the right to enforce satisfaction of a debt against a self-settled trust except in a bankruptcy proceeding, and it does not apply to a transfers more than 10 years prior to the bankruptcy. Thus, creditors' rights under federal bankruptcy law are significantly less than under the state law that exists outside the 16 states permitting self-settled trusts, and may not have the same effect for federal transfer tax purposes, especially where the transferor remains solvent at all times prior to death, with bankruptcy not more than a remote possibility. The application of 11 U.S.C. § 548(e) requires proof of an actual intent by the transferor to hinder potential future creditors, which may be absent when the transfer has significant other purposes.

f. If it is possible for a current or future creditor of an assigning beneficiary to reach part of the assets of a self-settled trust, then that part of the trust may not constitute a complete gift for gift tax purposes.

The IRS could argue that because of state property law, or federal bankruptcy law, the grantor/beneficiary could create a future creditor relationship, which would terminate part or all of the trust. That power by the assigning beneficiary would mean that the assigning beneficiary has retained dominion and control over that part of the trust, and has not completed a gift for gift tax purposes under Treas. Reg. § 25.2511-2(b).[87]

B. The Advantages and Considerations of a Transferor Selling Subchapter S Stock to a Qualified Subchapter S Trust ("QSST") Created By a Third Party That is a Grantor Trust as to the Subchapter S Stock, That Names the Transferor as a Beneficiary and Gives the Transferor a Special Limited Power of Appointment.

1. What is the technique?

A third party could create a trust for the benefit of a potential transferor to the trust, which would meet the requirements of a qualified Subchapter S trust (QSST) under IRC Sec. 1361(d). The potential transferor could create, or may have already created, a Subchapter S corporation to hold his investment assets and/or trade or business. The transferor could then sell his voting and/or nonvoting stock that he has in the Subchapter S corporation to the QSST that has been created by a third party. It is important that the sale be in consideration of a secured note in which the security is the transferred stock and all distributions on that stock.

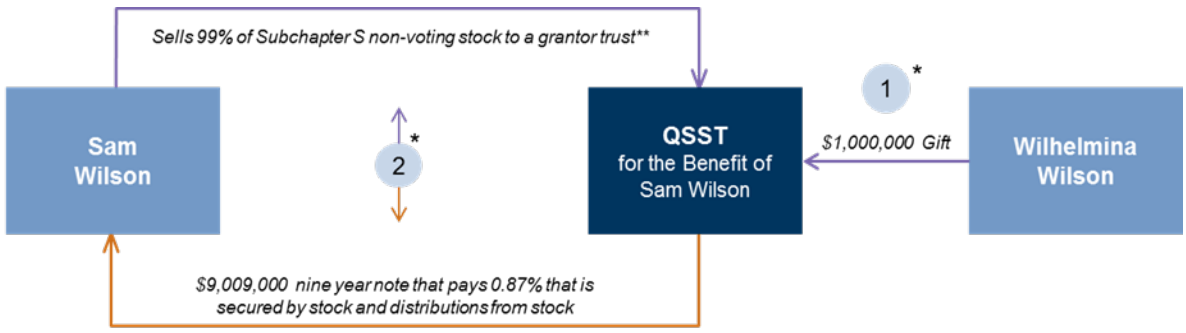
[87] *See Outwin v. Commissioner*, 76 TC 153 (1981), acq. 1981-2 CB 1; *Herzog v. Commissioner*, 116 F2d 591 (2d Cir. 1941).

Consider the following example:

Example 8: A Third Party Creates a QSST For the Benefit of a Transferor and Then the Transferor Sells, For a Secured Note, the Transferor's Non-Voting Stock in a Subchapter S Corporation to the Qualified Subchapter S Corporation to the Trust

Sam and Sally Wilson own $32,000,000 in financial assets. Sam owns around $13,000,000 of their financial assets, which constitute private equity investments and/or financial assets that have a relatively low basis ($2,000,000). For valid non-tax reasons, including concerns about future ownership of the assets under the qualified purchaser and accredited investor rules, Sam Wilson decides to incorporate that $13,000,000 of these assets in a Subchapter S corporation. His mother, Wilhelmina Wilson contributes $1,000,000 to a dynasty trust that could qualify to be a QSST. Sam, as the income beneficiary of the trust, has a right to principle distributions of the trust for his support and maintenance. Sam also has a limited testamentary power of appointment to appoint the trust assets to his family and/or Sally. Sam sells his non-voting stock (which represents 99% of the capitalization of the Subchapter S corporation) to the QSST in exchange for a secured note. The security for the note is the stock that is sold and the distributions from that stock. It is assumed that the estimated pre-tax rate of return of the Subchapter S corporation will average 12% a year. It is also assumed that the rate of return on the remaining financial assets of Sam and Sally will average 7.0% a year pre-tax. It is assumed that Sam and Sally will consume $250,000 a year as adjusted for inflation.

This technique is illustrated below:



* These transactions need to be separate, distinct and independent.

** It is assumed there is a 30% discount and the Subchapter S assets are worth $13,000,000.

Under IRC Sec. 1361(d)(1)(B) the transferor (as a beneficiary of the QSST) will be treated as the owner of the Subchapter S stock held in trust under IRC Sec. 678(a). Under IRC Sec. 678(a) the trust is ignored for income tax purposes, at least with respect to any Subchapter S stock that is held in the trust. It should be noted that the trust assets other than the Subchapter S stock will be taxed under the normal Subchapter J rules. Thus, the sale of Subchapter S corporation stock should not trigger any capital gains consequences to the transferor, if he sells to

a trust that qualified as a QSST,[88] because the seller is considered the owner of the stock both before and after the sale for income tax purposes. A QSST, while it owns Subchapter S stock, may have only one beneficiary (who also must be a U.S. citizen or resident), all of its trust accounting income[89] must be distributed to that beneficiary. The beneficiary may receive corpus during the beneficiary's lifetime. The beneficiary must elect to be taxable on the income of the QSST.[90] The beneficiary may have a testamentary power of appointment.

Can the distributions from the Subchapter S corporation stock owned by the QSST, which are collateral on the transferor's note, be used to retire both the principal and interest of the note on which the QSST is the obligor? Clearly interest on a note is a charge against the income of a trust for trust accounting purposes and should be paid by the trustee of the QSST. *See* Sec. 501(3) of the Uniform Principal and Income Act. The distributions on the purchased Subchapter S stock can also be used by the trustee of the QSST to retire the principal on the note, if the distributions are security for a note on which the QSST is the obligor. Compare the interaction of Secs. 502(b) and 504(b)(4) of the Uniform Principal and Income Act. There may need to be an equitable adjustment between the principal and income of the trust when the distributions from purchased Subchapter S stock are used by the trustee of the QSST to retire principal of the debt used for that purchase, depending upon the interaction of Secs. 502(b) and 504(b)(4) of the Uniform Principal and Income Act. The fact that Subchapter S distributions are part of the security for the debt, and are used to retire the principal of the debt, does not disqualify the trust from being a QSST.[91]

2. Advantages of the technique.

a. May provide better defenses to the bona fide sale considerations of IRC Secs. 2036 and 2038 Than the beneficiary grantor trust that is funded with $5,000 described below.

Unlike the BDIT described *infra* Section IX.D, a settlor may contribute much more than $5,000 to the trust in order to provide substantive security on any leveraged sale of Subchapter S stock to the trust, which may help on the bona fide sale considerations of IRC Secs. 2036 and 2038.

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[88] *See* Rev. Rul. 85-13, 1985-1 C.B. 184 and the authorities discussed therein. This Revenue Ruling involved the sale to a trust that was not a grantor trust before the sale. However, because of the terms of the sale, the trust became a grantor trust and the seller was considered the owner of the sold trust property both before and after the sale. The same analysis would appear to apply for a sale, of Subchapter S stock by a Subchapter S owner to a QSST held for his benefit, even if the QSST was not a grantor trust under IRC Sec. 678 until the sale. The seller of the Subchapter S stock to a QSST, held for the benefit of the seller, should be considered the income tax owner of the sold Subchapter S stock both before and after the sale. Thus, no capital gains consequences should arise.

[89] *See* Treas. Reg. Section 1.1361-1(j)(i).

[90] Under IRC Sec. 1361(d)(2)(D), the election can be retroactive for up to two months and fifteen days, so a timely election will cause IRC Sec. 678 to apply at the time of the sale.

[91] *See* PLR 914005 (June 25, 1991); PLR 200140046 (Oct. 5, 2001).

b. Circumvents federal capital gains tax treatment on the sale of the subchapter S stock.

Under Internal Revenue Ruling 85-13, a sale by a taxpayer of an asset to a trust (that was not a grantor trust until the purchase occurred) in which the taxpayer is considered the owner of the trust asset for income tax purposes, both before and after the sale, is not subject to federal capital gains taxes. See the discussion in Section III.B.1 of this paper. That Revenue Ruling discussed and followed a B.T.A. case, which held that a purchase of an asset from a bankruptcy trustee should be ignored for income tax purposes if the purchaser owned the asset both prior to and after the bankruptcy proceeding. Under IRC 1361(d)(1)(B), the beneficiary of a QSST is treated as the owner under IRC Sec. 678(a)(1) of that portion of the trust, which consists of Subchapter S corporation stock. If the beneficiary of the QSST sells Subchapter S stock that he individually owns to the QSST, he will own the stock for income tax purposes both before and after the sale. It should be noted that under Treasury Regulation Sec. 1.1361-1(j)(8), if there is a sale at a later time of the Subchapter S stock to a third party by the trustee of the trust, that sale will be taxable to the trust under the usual principles of Subchapter J.

c. There is not any concern about the effect of any lapse of withdrawal rights.

Unlike the BDIT discussed *infra* Section IX.D, there is no need for the beneficiary of the QSST to have withdrawal rights, because there is no attempt to make the entire QSST a grantor trust, and withdrawal rights are not necessary for the Subchapter S stock to constitute a grantor trust portion of the QSST. The transfer tax and income tax consequences that may accrue from the existence of a withdrawal right, and from its lapse, are not present in this technique.

d. It has the advantage of allowing the seller to be a beneficiary of the trust and have a power of appointment over the trust.

Compare the discussion of the spousal grantor trust *supra* Section IX.A.

e. It has the potential of mitigating gift tax surprises.

See discussion *supra* Section IX.A.

3. Considerations of the technique.

a. The disadvantage of utilizing a subchapter S corporation.

A Subchapter S corporation is generally more advantageous from an income tax standpoint than a Subchapter C corporation, because there are not any corporate taxes to be paid for a corporation that qualifies. A Subchapter S corporation can own passively managed assets, if the corporation has never been a C corporation.

One of the disadvantages of a Subchapter S corporation is that only certain shareholders may qualify. Shareholders must be United States citizens. To the extent the Subchapter S stock is owned by a trust, the trust needs to be a grantor trust, a QSST or an electing small business trust

(ESBT). Of these, the only trusts to which sales of Subchapter S stock may be without realization of gain are grantor trusts (sale by the grantor) and QSST trusts (sale by the trust beneficiary).

Another disadvantage of a Subchapter S corporation is that there is not a step up on the underlying assets of the Subchapter S corporation on the death of the shareholder who owns stock that is subject to estate taxes. FLPs and limited liability companies, pursuant to certain elections that can be made under IRC Sec. 754, have the ability to have certain of the partnership assets receive an internal basis step up on the death of a partner or member who owns the partnership interest or member interest (assuming the assets have appreciated). However, this may not be a significant consideration, if the planning goal is to have the stock out of the client's estate by the time of the client's death. Obviously, there would also not be a basis change under that goal and those facts, even if a partnership was used in the transfer planning – one cannot receive a basis step up on assets one does not own at death.

b. Need to file a federal gift tax return.

See discussion *supra* Section IX.A.3.

c. Federal income tax considerations.

The income from the Subchapter S stock that is owned by the QSST trust will be taxed to the beneficiary, which is generally an advantageous result for federal transfer tax purposes. If the logic of Rev. Rul. 85-13 applies, the note should not be recognized for income tax purposes and the transferor should not be taxable on the interest on the note.

If the note is recognized for income tax purposes, the interest on the note should be deductible to the beneficiary of the trust (i.e., the transferor) under the separate share rules of IRC Sec. 663 or because of the fact that interest, at least to the extent paid from distributions from the S corporation, is being paid from the grantor portion of the QSST. Thus, if the note is recognized, both the interest income and the interest expense (which should constitute a "wash") should be reported on the transferor's income tax return. In the situation in which a QSST purchases S corporation stock from a third party (not the beneficiary) in exchange for a note the Office of the Chief Counsel ruled that the interest expense associated with the debt incurred by the QSST to acquire the S corporation stock is allocated to the grantor trust portion of the QSST thereby allowing the beneficiary to report the interest expense as a deduction on his personal income tax return.[92]

The Chief Counsel provided in the analysis the following:

> …Section 1.1361-1(j)(8) reiterates that the grantor is deemed to own the portion of the QSST consisting of the S corporation stock, but creates an exception when the QSST is determining and attributing the federal income tax consequences of a

[92] CCA 201327009 (May 1, 2013).

> disposition of the S corporation stock. However, even within this exception there is an exception that again emphasizes the beneficiary's ownership interest. When the QSST disposes of the S corporation stock, the beneficiary is treated as personally disposing of the S corporation stock for purposes of applying §§ 465 and 469 to the beneficiary.
>
> Applying the rules in § 1361(d), the S corporation stock is treated as though it is held in a grantor trust (the S portion). We should, therefore, look to the rules of subchapter J to determine which portion of the QSST receives the interest expense allocation. Under § 671 and the regulations thereunder, all items of income and deduction directly related to the grantor trust are attributed to the grantor. …
>
> The regulations under § 652(b) provide guidance for determining what deductions are allocable to different classes of income held by a trust. Section 1.652(b)-3(a) provides that all deductible items that are directly attributable to one class of income are allocated to that class. …
>
> The rules under § 163 provide guidance to determine to which class of income the interest expense incurred by the trust is allocated. The interest tracing rules (§ 1.163-8T) provide guidance in allocating interest expense for purposes of applying §§ 469 and 163(d) and (h). Section 163(d) limits the deduction for investment interest and § 163(h) allows a deduction for all but personal interest. The interest tracing rules provide that interest on a debt is allocated in the same manner as the debt to which the interest expense relates is allocated.
>
> …

Therefore, § 1.671-3(a)(2) would seem to require that based on § 1.652(b)-3 the interest expense deduction should be attributable to the S portion of the QSST and, thus, deductible by the beneficiary.

Any assets of the trust that are not Subchapter S stock will be taxed trust under normal Subchapter J rules.

As noted above, under Treas. Reg. Sec. 1.1361-1(j)(8), if there is a sale by the trustee of the QSST of any Subchapter S stock owned by the QSST, the QSST will be taxed on that sale under normal Subchapter J principles. The basis of the Subchapter S stock, that is to be sold, could be low because the only basis step up will be the accumulated income of the corporation after the sale by the Sec. 678 owner of the QSST. It may be very important to eliminate any note outstanding to the Sec. 678 owner of the QSST, before the QSST sells its Subchapter S stock to a third party, in order to circumvent any income tax complications associated with the outstanding debt.

d. State income tax considerations.

Certain states may have different tax rules with respect to Subchapter S corporations and the taxation of QSST trusts. Thus, the possibility exists that under certain state laws, a sale to a

QSST trust may be subject to state capital gains taxes and the beneficiary of the trust will not be taxed on the trust income.

e. Creditor rights and related estate tax issues.

See discussion *supra* Section IX.A.3.e.

f. Incomplete gift issues.

See discussion *infra* Section IX.A.3.f.

g. The transferor is the only beneficiary of the trust.

If the transferor wishes to have the flexibility to transfer trust assets to another family member, this technique will not allow the beneficiary to accomplish that purpose during the transferor's lifetime. However, the transferor could use other techniques to benefit the transferor's family.

C. The Advantages and Considerations of a Transferor Selling Assets to a Third Party Created Trust That is a Beneficiary Deemed Owner Trust ("BDOT") in Which the Transferor, as the Beneficiary of the BDOT, Has the Power to Withdraw in Any Calendar Year of the Trust, at Anytime During the Calendar Year, the Greater of 5% of the Trust Corpus or All of the Net Taxable Income[93] of the Trust, and That Withdrawal Power Can Be Satisfied Out of the Entire Income and/or Corpus and/or Proceeds of the Corpus of the Trust. [94]

1. The technique.[95]

A third party could create an inter vivos or testamentary estate tax protected trust, of any value, in which the beneficiary is the deemed income tax owner. This technique allows significant initial funding, which is different than the beneficiary defective inheritor's trust ("BDIT") that is described *infra* Section IX.D.1, which generally is only funded with $5,000 of

[93] While the term "net taxable income" is not a defined term under trust property law the elements of net taxable income can be determined under trust property law.

[94] Such a withdrawal power should distinguish the holding of the court in Fish v. U.S., 432 F2d 1278 (9th Cir. 1970) and the IRS in Revenue Ruling 85-88, 1982-2 C.B. 201 that the 5% lapsed protection from transfer taxes provided by IRC Secs. 2514(e) and 2041(b)(2) is only measured by 5% of the accounting income of the trust when the withdrawal right only applies to accounting income. The measure of the greater of 5% of the trust corpus or all of the net taxable income withdrawal power should be 5% of the corpus value of the trust. See Treas. Reg. §25.2514-3.

[95] For an in depth discussion of the BDOT technique, please *see* Ed Morrow "IRC § 678(a)(1) and the "Beneficiary Deemed Owner Trust '(BDOT)' (Leimberg Information Services, Inc., September 5, 2017). It could be noted that this paper differs from Mr. Morrow's paper as to how the withdrawal right should be designed. For instance, there may be certain IRC Sec. 678 concerns for a tax year if the beneficiary does not have the unfettered right to withdraw net taxable income for the full year. *See also* IRC Secs. 678 and 671 and Treas. Reg. §§1.678(a)-1, 1.671-2 and 1.671-3.

assets when it is created. Under IRC Sec. 678(a)(1), if a beneficiary of a third party created trust has the unilateral power to "vest income" of a trust then the trust is disregarded for income tax purposes and the net taxable income of the trust is taxable to the beneficiary. In order to vest income of the trust, the beneficiary of the trust should have the unilateral power to withdraw all of the net taxable income of the trust to himself, with all of the assets of the trust being available to satisfy that withdrawal power, including the trust's accounting income, the trust's corpus and the trust's proceeds from sales of the trust corpus.

IRC Sec. 678(a)(1) provides as follows:

> **(a) GENERAL RULE** A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:
>
> > **(1)** such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself. . .

The reference to "income" in IRC Sec. 678(a)(1) is taxable income and not accounting income.[96] If a beneficiary of a BDOT has the right to withdraw net taxable income, the beneficiary has the right to withdraw not only dividends and interest, but income normally allocated to principal such as capital gains income.[97]

Example 9: A Parent Creates a $2,000,000 BDOT for the Benefit of Her Daughter and Her Daughter Sells to the BDOT Significant Assets in Two Different Cascading Sales

In 2016, Betsy Bossdaughter created a single member FLLC with a 0.01% Class A managing member interest, a 0.99% Class B managing member interest and a 99% non-managing member interest and the FLLC held $57,000,000 in assets (Transaction 1 below). In 2017 Granny Selfmade transfers $2,000,000 in assets to a BDOT that is also a GST exempt trust (Transaction 2 below). (Note: Granny could create the trust by her will, or during her lifetime, if Granny retains no interest or power that would cause her to be taxed on the trust income under the grantor trust rules.) The terms of the BDOT provide Granny's daughter, Betsy Bossdaughter, the power to withdraw in any calendar year of the BDOT all of the net taxable income of the BDOT. The terms of the BDOT provide that withdrawal power can be satisfied out

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[96] While the term "net taxable income" is not a defined term under trust property law, the elements of net taxable income can be determined under trust property law.

[97] Such a withdrawal power should distinguish the holding of the court in *Fish v. U.S.*, 432 F2d 1278 (9th Cir. 1970) and the IRS in Revenue Ruling 85-88, 1982-2 C.B. 201 that the 5% lapsed protection from transfer taxes provided by IRC Secs. 2514(e) and 2041(b)(2) is only measured by 5% of the accounting income of the trust when the withdrawal right only applies to accounting income. Since the withdrawal power in the BDOT technique is the greater of 5% of the corpus or all of the net taxable income (which includes capital gains income) and since the withdrawal power can be satisfied out of accounting income, sale proceeds of corpus and the corpus, the measure of the IRC Sec. 2514(e) and IRC Sec. 2041(b)(2) lapsed protection should equal 5% of the corpus value of the trust. See Treas. Reg. §25.2514-3 and the discussion *infra* Section IX.C.4.a.

of the entire income, corpus, or proceeds of the corpus of the trust. If Betsy does not exercise her withdrawal power in any calendar year it will lapse. Betsy is also given a special testamentary power of appointment in the BDOT trust documents. The remainder beneficiaries of the BDOT after her death, subject to the power of appointment, are Betsy's children and grandchildren.

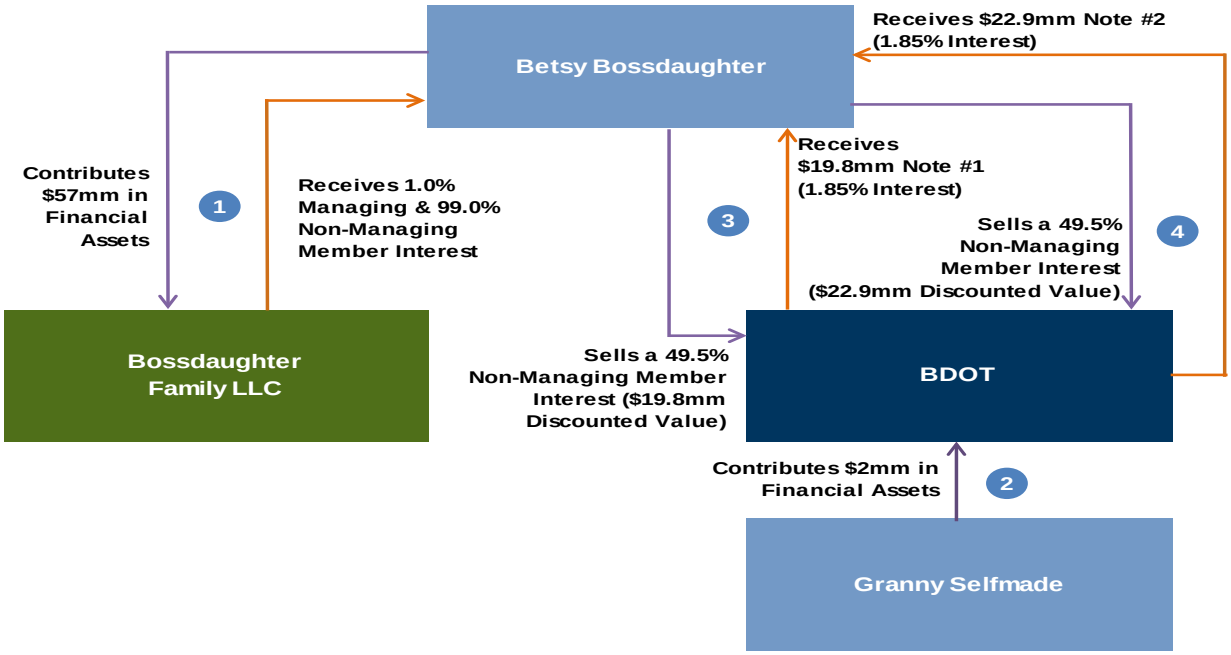
In 2018, Betsy sells a 49.5% non-managing member interest in her FLLC to the BDOT in exchange for $19,750,500 note (Transaction 3 below). Due to considerations with respect to retaining entity distribution, amendment and liquidation powers, Betsy could retain the 0.01% Class A managing member interest and transfer the 0.99% Class B managing member interest. The Class A managing member interests would control all entity managing member decisions, including investment management decisions that are not delegated to the Class B managing member interest. The Class B managing member interests would control all distribution, amendment and liquidation decisions. Betsy could give her Class B managing member interest to a grantor trust in which the initial trustee is an advisor or family member she trusts. Betsy could have the power to replace the trustee of that donee trust with a new trustee, as long as the replacement trustee is not related or subservient.

It is assumed there is a 30% valuation discount associated with the sold 49.5% non-managing member interest. The assets in the FLLC and the $2,000,000 in the BDOT outside of its ownership of the FLLC annually grow at 6% per year pre-tax. In 2021, Betsy sells her remaining 49.5% non-managing member interest in her FLLC in exchange for a $22,896,243 note (Transaction 4 below).

Betsy needs $1,000,000 a year (inflation adjusted) for her consumption needs and also needs enough additional cash flow from the BDOT and her FLLC to pay her income taxes. Betsy plans to first look to payments on the note receivable from the BDOT for those consumption and tax payment needs.

Betsy asks her tax advisor, Mable Mathgeek, how many years will it take the BDOT to pay off her note receivables under those above assumptions and what will be the undiscounted value of the BDOT assets when that note is paid off?

The technique is illustrated below:



Under the above assumptions, the BDOT will have paid all of its note receivables in 27 years. At that point, the undiscounted value of the BDOT assets will be worth $126,613,473. *See* the calculations *infra* Schedule 9. After the note is totally paid, going forward, Betsy could use her withdrawal power over the BDOT to satisfy her consumption and tax payment needs. The assets of the BDOT, if the trust document is properly drafted and the trust is properly administered, will not be subject to Betsy's estate tax. Furthermore, Betsy may use her retained transfer tax exemptions to engage in additional estate planning. *See* Schedule 9 for detailed calculations and the table below for a summary of those calculations based on the above assumptions and assuming Betsy dies in 30 years.

Table 5

	Bossdaughter Children (1)	Bossdaughter Children & Grandchildren (2)	Consumption		IRS Income Tax			IRS Estate Tax (@ 40%) (8)	Total (9)
			Direct Cost (3)	Investment Opportunity Cost (4)	Direct Cost (5)	Investment Opportunity Cost (6)	Embedded Capital Gains Tax (7)		
30-Year Future Values									
No Further Planning	$89,948,174	$22,759,465	$43,902,703	$60,266,542	$27,710,079	$34,146,049	$167,518	$59,965,449	$338,865,979
Hypothetical Technique	$0	$169,144,803	$43,902,703	$60,266,542	$28,775,165	$34,146,049	$2,630,716	$0	$338,865,979
Present Values (discounted at 2.5%)									
No Further Planning	$42,882,134	$10,850,408	$20,930,293	$28,731,633	$13,210,577	$16,278,879	$79,863	$28,588,089	$161,551,877
Hypothetical Technique	$0	$80,638,548	$20,930,293	$28,731,633	$13,718,349	$16,278,879	$1,254,175	$0	$161,551,877

2. Income tax advantages of the technique.

a. The technique has all of the income tax advantages of the LAIDGT technique. [98]

The BDOT is treated as a grantor trust to the beneficiary based on IRC Sec. 678, which is basically a codification of the *Mallinckrodt* case.[99] Thus, a sale by the beneficiary of the BDOT to the BDOT has the same advantages as the LAIDGT or the SIDGT techniques. *See* the discussion *supra* Sections III.B and III.C.

b. Failing to take the withdrawing income is not relevant to the IRC Sec. 678 analysis.

Such a power has even been ruled effective when held by a minor even where there was no court-appointed guardian with authority to exercise the power. [100]

c. The BDOT can be designed to be very flexible for any calendar year by giving an independent trustee, or a protector, the power to change the withdrawal power for a future year or years.

d. The BDOT has many income tax advantages that a complex trust does not have.

(1) The taxable income is taxed at the beneficiary's marginal tax rate, which is frequently lower than the trust's marginal tax rate.

(2) The beneficiary of a BDOT can take an IRC Sec. 179 expense deduction while a complex trust's ability to take that deduction is limited.

(3) Depending upon the BDOT beneficiary's tax bracket, and/or how active the beneficiary is in a closely held business, the 3.8% net investment income tax will not

[98] If the reader is concerned that Revenue Ruling 85-13, 1985-1 CB 184, only disregards, for income tax purposes, sales and purchases from grantor trusts described in Sections 671-677, but does not necessarily provide authority that a sale or purchase from a trust that is taxed to the beneficiary under Section 678 is disregarded, consider structuring the transaction using a leveraged single member LLC. *See* the discussion *supra* Section II.B. While the regulations under Section 671-678 do not specifically hold activities with grantor trusts are disregarded, the regulations with respect to LLCs that are taxed as a single member LLC make it clear single member LLC activities (including sales and purchases) are disregarded.

[99] *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir. 1945).

[100] *Trust No. 3 v. Commissioner*, 285 F.2d 102 (7th Cir., 1960).

apply while under the same circumstances it may apply to a complex trust.

(4) The BDOT can be a shareholder of a S corporation without some of the considerations of an ESBT.

The beneficiary of a BDOT may be entitled to certain deductions that are eliminated by ESBTs. A QSST has to pay the trust accounting income of the QSST to the beneficiary, while a BDOT does not pay any income to the beneficiary unless the withdrawal right is exercised.

e. Capital losses can be passed through to the beneficiary of the BDOT.

Assets that have a capital loss could be distributed in kind.

f. The capital gains benefit of a residence that is inherent under IRC Sec. 121 will be available to sales of residences owned by a BDOT.

g. There are increased opportunities for charitable planning because the inherent limitations under IRC Sec. 642(c) will be eliminated.

The beneficiary can withdraw assets that accrued from sources other than gross income in satisfaction of its withdrawal right and those assets can then be contributed by the beneficiary to charities.

h. A BDOT should avoid overlapping state fiduciary income taxation.

i. The consideration of the BDIT losing part of its beneficiary deemed owner status, when it is substantially funded, if it is designed to have an initial pecuniary withdrawal right, does not exist with the BDOT technique.

See discussion *infra* Section IX.E.3.d.

3. Transfer tax advantages and some additional income tax benefits.

a. The beneficiary has the opportunity by her actions to increase the value of the BDOT and, thus, the amount that is not subject to estate taxes.

To the extent the beneficiary of a BDOT does not withdraw net taxable income of the BDOT up to the lapse protection (the so-called "5 and 5" protection of IRC Sec. 2041(b)(2)), that amount remains in the trust in a manner that will not be subject to estate taxes. Almost all states have legislation that protects the protected lapse portion described in IRC Secs. 2514(e)(2) and 2041(b)(2) from creditors. However, to the extent that a current or hanging power exists at death

or a prior power lapsed in excess of the lapse protection, property could be accessible by creditors of the beneficiary and that portion of the BDOT will be subject to the beneficiary's estate taxes. The beneficiary may maximize the lapse protection by always withdrawing that amount of net taxable income (payable out of income or corpus of the trust) that exceeds 5% of the value of the corpus of the trust. *See* discussion *infra* Section IX.C.4.a. It should be noted that under this Example 11, the right to withdraw could be designed to only occur if the trust and/or protector has not removed that withdrawal right in a prior year.

b. Because the beneficiary is the deemed income tax owner of the BDOT, there is flexibility to allow the beneficiary to sell life insurance policies to the BDOT.

c. The BDOT can own non-qualified deferred annuities.

It is very difficult for a complex trust to own non-qualified deferred annuities because of the requirements under IRC Sec. 72.

d. The BDOT technique has a greater safety valve than the SIDGT for protecting the seller, since the seller both has withdrawal rights in and is a discretionary beneficiary of the BDOT.

4. Considerations of the technique.

a. In order to receive the lapse of power transfer tax protection of IRC Secs. 2041(b)(2) and 2514(e)(2), it is Important that the withdrawal power can be applied against the entire income and/or corpus and/or proceeds of the entire corpus, of the BDOT.

It is important that any withdrawable, but untaken, BDOT funds be protected from being considered a contribution by the beneficiary of the BDOT for transfer tax purposes. The requirements under the tax law for those withdrawable, but untaken, BDOT funds to not be considered a transfer for transfer tax purposes are: (i) those BDOT funds cannot exceed more than 5% of the value of the property of the BDOT; (ii) those BDOT funds could have been paid from the entire property, or proceeds from the property, of the BDOT, and (iii) creditors cannot reach those BDOT funds after the right to withdraw them expires.

In order to meet the statutory requirements of IRC Secs. 2041(b)(2) and 2514(e)(2), the withdrawable, but untaken, funds cannot exceed 5% of the value of the property of the BDOT. If the net taxable income is projected to exceed 5% of the value of the property of the BDOT (in many years of most BDOTs, that would not be the case) the beneficiary could withdraw that excess net taxable income above that value equal to 5% of the BDOT. For instance, if it is assumed the net taxable income of the BDOT is equal to an amount that is 6% of the value of the corpus of the BDOT, the beneficiary could withdraw one-sixth of the net taxable income of the trust. In that fashion the withdrawable, but untaken BDOT funds will be equal to the 5% safe harbor of IRC Secs. 2041(b)(2) and 2514(e)(2). Secondly, the use of hanging powers of withdrawal could also mitigate the transfer tax issue.

Revenue Ruling 66-87[101] highlights the importance of making sure the BDOT funds available for withdrawal can be paid from the entire property and/or proceeds of the property of the BDOT. That revenue ruling focused on the effect of a power to withdraw accounting income (not net taxable income from all sources including capital gains sales) that was not withdrawn. The revenue ruling concluded the 5% lapse protection is calculated based on the amount of that accounting income only and is not calculated based on the corpus of the requisite trust. In issuing Revenue Ruling 66-87, Treasury assumed that the trust document did not permit the withdrawal powers to be satisfied from all of the trust assets.

In light of the above considerations, the beneficiary of a BDOT who does not wish to be out of pocket gift taxes or income taxes on a net basis, may wish to notify the trustee of the BDOT, in any calendar year, that he or she desires to withdraw that amount of net taxable income that is the greater of (i) that amount of net taxable income that the beneficiary has previously notified the trustee that he or she wishes to withdraw; (ii) that amount of net taxable income that is equal to the income taxes owed by the beneficiary of the BDOT; or (iii) that amount of net taxable income that exceed 5% of the value of the corpus of the trust.

b. If creditors can reach part of the withdrawable, but untaken, BDOT funds under the appropriate state law or because the sale described above was for inadequate consideration, those circumstances may lead to significant transfer tax consequences.

In both of those circumstances the BDOT beneficiary would become a deemed settlor of a portion of the BDOT in addition to the original settlor. The amount that could be included in the BDOT beneficiary's estate, if the sale is for inadequate consideration may be considerable, depending on the growth of the asset that is sold between the time of the sale and the beneficiary's death. Because of the operation of IRC Secs. 2036 and 2043, the full value of the sold asset will be included in the beneficiary's estate minus the value of the note at the time of the sale. In that event, the part that the creditors can reach will be taxable in the BDOT beneficiary's estate, whether or not that BDOT beneficiary has those potential creditors. *See* the discussion *supra* Section IX.A.3.e.

(1) However, almost all states have legislation that protects against the BDOT beneficiary's creditors reaching the withdrawable, but untaken, BDOT funds.

Not only do the states that permit self-settled trusts protect against those potential creditors, but almost all states have legislation that protects against creditors reaching lapsed withdrawals that are 5% or less of the value of the corpus of a trust.

[101] Rev. Rul. 66-87, 1966-1 C.B. 217.

(2) Secondly, a BDOT could be drafted to allow an independent trustee or a protector to remove the withdrawal power that is inherent in a BDOT trust structure in future years.

(3) In order to avoid the consequences of a sale for inadequate consideration, strong consideration should be given to the BDOT beneficiary using a defined value allocation assignment or a defined dollar transfer when he makes the sale. *See supra* Section III.C.5.

c. The sale of assets to a BDOT has most of the considerations of a SIDGT (*see* discussion *supra* Section III.D), with the following exceptions.

(1) There is less danger that the sale to a BDOT will be a taxable gift because of the presence of the seller's beneficial interest and special power of appointment over the BDOT, may make the gift an incomplete gift.

(2) The grantor trust status can remain longer because of the seller's beneficial interest in the trust.

There is a greater safety valve protection for the BDOT seller's lifestyle needs because the seller is also a beneficiary of the BDOT.

(3) There may be a greater opportunity to convert the retained note to a private annuity.

d. The sale of assets to a BDOT has some of the considerations of a sale to a BDIT (*see* discussion *infra* Section IX.D.3).

(1) Because the BDOT can be substantially funded, the sale will not be as highly leveraged as a sale to a BDIT. However, the beneficiary of the BDOT has a right to the trust's taxable income, which is not the case with a BDIT.

(2) It is essential that the sale to the BDOT be a bona fide sale for full and adequate consideration, for gift tax purposes and for purposes of IRC Secs. 2036 and 2038. See the discussion of transfer tax issues *infra* at IX.D.3.b(4). Unless the sold assets are easy to value, consideration should be given to structuring the sale as a defined value assignment or a defined value allocation assignment. *See* the discussion *supra* Section III.C.5.

D. The The Advantages and Considerations of a Transferor Selling Assets to a Third Party Created Trust That Generally Only Has $5,000 of Corpus (a "Beneficiary Defective Inheritor's Trust" or "BDIT"), That Names the Transferor as a Beneficiary, and Under Which the Transferor is Considered the Income Tax Owner; With the Consideration of the Sale Being a Note That is Guaranteed By a Grantor Trust the Transferor Has Previously Created (the "$5,000 BDIT Guaranteed Sale Technique").

1. What is the $5,000 BDIT guaranteed sale technique?

A BDIT is a trust that is a grantor trust, not as to the trust's settlor (the "Settlor") but as to a trust beneficiary (the "beneficiary"). That is, the trust is specifically designed not to trigger any of IRC Secs. 673, 674, 675, 676, 677 or 679, but intentionally to trigger IRC Sec. 678.

Consider the following example:

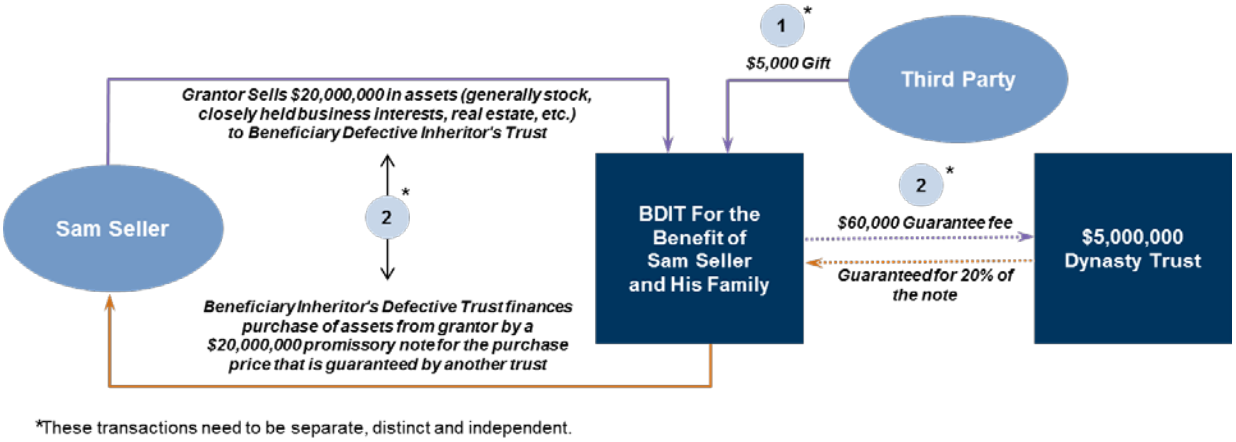
Example 10: A Leveraged Sale By a Transferor to a $5,000 BDIT in Which the Note is Guaranteed By the Transferor's Spouse or a Third Party Trust

Sam Seller is the beneficiary of a BDIT that has $5,000 as its sole asset and was created by a third party (Transaction 1 below). Sam has the power to withdraw $5,000 when the trust is created. Sam does not exercise that power and the power lapses. The $5,000 then passes to a trust in which distributions may be made to Sam under an ascertainable standard and under which Sam has a special power of appointment. That trust is designed not to be taxed in Sam Seller's estate. The trust is also designed where Sam Seller will pay all of the income taxes of the trust under IRC Sec. 678.

Previously, Sam had contributed $5,000,000 to a dynasty trust, which has the same beneficiaries as the BDIT, excluding Sam. Sam does not have a power of appointment over that $5,000,000 dynasty trust. The $5,000,000 dynasty trust is a grantor trust to Sam.

Sam sells assets equal to $20,000,000 to the BDIT (Transaction 2 below). The $5,000,000 generation-skipping trust guarantees the note up to $4,000,000. The BDIT pays a guarantee fee equal to one and one-half percent of the $4,000,000 guarantee, or $60,000 a year.

The $5,000 BDIT Guaranteed Sale technique is illustrated as follows:



2. It has all the potential income tax advantages of the BDOT technique.

See the discussion *supra* Section IX.C.1.

3. Potential transfer tax advantages of the $5,000 BDIT guaranteed sale technique.

If the technique works, it has many of the same advantages as the sale to a grantor trust with the additional exit strategies of the transferor not only having access to the cash flow from the note, but also having access to the cash flow of the trust for his or her support and maintenance. Additionally, if the technique works, the transferor has the ability to change his or her mind as to future stewardship goals through the power of appointment mechanism.

In Revenue Procedure 2013-3 Section 4.01 (43), the IRS announced it would not rule on this transaction if "the value of he assets with with the trust was funded by the grantor is nominal compared to the value of the property purchases." Some of the considerations that may have led the IRS to the "no ruling" policy are noted below.

4. Transfer considerations of the $5,000 BDIT guaranteed sale technique.

a. Does the guarantee fee have substance?

There is considerable pressure on the technique because of the need to pay the guarantee fee to the third party. A guarantee fee is probably necessary because the guarantor trust may not be the remainder beneficiary of the BDIT.[102] The IRS may question the substance of any guarantee fee in the hypothetical transaction illustrated above because of the significant ratio of that guarantee fee in comparison to the beginning corpus of the BDIT. Under this example, the

[102] *See* PLR 9113009 (Dec. 21, 1990), which was withdrawn for other reasons; *see also* Martin M. Shenkman, "Role of Guarantees and Seed Gifts in Family Installment Sales," 37 Estate Planning 3 (Nov. 2010).

corpus of the BDIT is $5,000 and the guarantee fee to be paid is $60,000 a year for the years the guarantee is outstanding. That is, the annual guarantee fee is *twelve* times the beginning corpus of the $5,000 trust. The IRS may take the view that the substance of the transaction, despite the guarantee, is a sale for a $20,000,000 note to a $5,000 "naked" trust that, under these circumstances, may have gift tax consequences under IRC Sec. 2702 (if the beneficiary does not have a special power of appointment), and estate tax consequences under IRC Secs. 2036 and 2038. Stated differently, the IRS may take the view that the risk/reward ratio of the guarantee fee by the BDIT is not commercial and there is no substance in the protection of the guarantee. The IRS' position could be, in reality, there is little risk in the guarantee by the BDIT in comparison to its potential reward. The BDIT, under this example, has *de minimis* "skin" in the game. *Thus, the IRS may take the view that the substance of the integrated transaction inherent in the $5,000 BDIT Guaranteed Sale is that, under equitable tax principals, two gifts for a total of $5,005,000 were made to a dynasty trust that has two grantors (i.e., one grantor contributed $5,000,000 and one grantor contributed $5,000), followed by a sale of $20,000,000 in financial assets to that dynasty trust, whose terms provide that the dominant grantor retains certain beneficial interests and certain powers to change the trust.*

b. Additional discussion of the transfer tax issues with the $5,000 BDIT guaranteed sale technique.

(1) In general.

Often (though not always) the purpose of creating a BDIT is to enable the beneficiary to sell property to the trust without incurring a capital gains tax, because the trust is a grantor trust as to the beneficiary, removing subsequent appreciation of the sold property from the beneficiary's gross estate. Of course, the beneficiary could sell property to a grantor trust of his own creation without capital gains tax, and doing so has become a standard estate planning technique. The advantage of the BDIT, if it works, is that the beneficiary may have interests in and powers over the BDIT that the beneficiary could not have with respect to an ordinary, self-settled grantor trust, without causing the trust property to be included in the beneficiary's gross estate, because these interests and powers will be treated as conferred upon the beneficiary by the settlor of the trust, rather than retained by the beneficiary.[103]

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[103] Richard A. Oshins, Larry Brody & Katarinna McBride, "The BDIT: A Powerful Wealth Planning Strategy When Properly Designed and Implemented," LISI Estate Planning Newsletter 1824 (June 22, 2011), at http://www.leimbergservices.com; Steven B. Gorin, "Beneficiary Grantor Trusts: A New Paradigm for Transferring Businesses," paper prepared for the ACTEC Business Planning Committee Summer 2011 Meeting (a shorter version is *A Balanced Solution*, Trusts & Estates 28-33 (May 2011)); Jeffrey A. Galant, "Beneficiary Grantor Trusts: Overview of Selected Issues," paper prepared for the ACTEC Business Planning Committee Summer 2011 Meeting; Jonathan G. Blattmachr & Diana S.C. Zeydel, "PLR 200449012 – Beneficiary Defective Trust(sm) Private Letter Ruling," LISI Estate Planning Newsletter 1559 (Dec. 10, 2009), at http://www.leimbergservices.com; Richard A. Oshins, Robert Alexander & Kristen Simmons, "The Beneficiary Defective Inheritor's Trust© ("BDIT"): Finessing the Pipe Dream," CCH Practitioner's Strategies (Nov. 2008); Richard A Oshins & Noel Ice, "The Inheritor's Trust™ Preserves Wealth as Well as Flexibility," 30 Est. Plan. 475 (Oct. 2003); Richard A Oshins & Noel Ice, "The Inheritor's Trust™: The Art of Properly Inheriting Property," 30 Est. Plan. 419 (Sept 2003); *see also generally*,

(2) Interests and powers of the beneficiary.

The proponents of the $5,000 BDIT Guaranteed Sale Technique assert that the beneficiary can have various interests and powers in the trust without causing inclusion in the beneficiary's gross estate. That is, the beneficiary's interests and powers will be tested under IRC Sec. 2041 rather than IRC Secs. 2035 and 2038.[104] If that is so, the beneficiary can have a limited testamentary power of appointment over the trust and the power will not cause inclusion, whereas the same power retained by the beneficiary in a trust he creates would cause inclusion under IRC Sec. 2038. Similarly, the beneficiary may have a power of withdrawal subject to an ascertainable standard (and, as we shall see, such a power may be helpful to preserve grantor trust status). Under IRC Sec. 2041 a power exercisable in favor of the powerholder does not cause inclusion if it is subject to an ascertainable standard. Under IRC Secs. 2036 and 2038, such a power may cause inclusion, if the beneficiary is the grantor of the trust.[105] Also, the beneficiary may be able to receive trust distributions in the discretion of an independent trustee. Such an interest will cause inclusion if the beneficiary's creditors can reach trust property under state law "creditors' rights" doctrine. Typically, creditors cannot reach trust property if the interest in the trust was conferred on the debtor-beneficiary by a third party, but can reach it if the interest was retained by the debtor or the debtor has a general power.[106]

(3) Who is the transferor for estate tax purposes with the $5,000 BDIT guaranteed sale technique?

It seems open to the IRS to argue that the beneficiary should be treated as the transferor for estate tax purposes of any property which the beneficiary, rather than the settlor, transfers to the BDIT, whether the beneficiary's transfer is a gift or a sale. For example, if the settlor of the BDIT transferred only one dollar to the trust and the beneficiary transferred ten million dollars by gift, it seems likely that the beneficiary would be treated as the transferor of the ten million, with inclusion in the beneficiary's estate governed by IRC Secs. 2036 and 2038 rather than IRC Sec. 2041. This result does not require applying the step transaction doctrine. It requires only the application of the principle that when an individual transfers property to a trust, interests in and powers over that that property which the individual possesses after the transfer will be treated as

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Jonathan G. Blattmachr, Mitchell M. Gans & Alvina H. Lo, "A Beneficiary as Trust Owner: Decoding Section 678," 35 ACTEC Law Journal 106 (Fall 2009).

[104] Cf. Treas. Reg. Section 20.2041-1(b)(2).

[105] Cases have excepted retained powers to distribute to someone other than the powerholder from IRC Secs. 2036(a)(2) and 2038 where the power was subject to an ascertainable standard. *Jennings v. Smith*, 161 F. 2d 74 (2d Cir. 1949); *Estate of Budd v. Commissioner*, 49 T.C. 468 (1968), acq. 1973-2 C.B. 1; *Estate of Pardee v. Commissioner*, 49 T.C. 140 (1968); *see also Old Colony Trust Co. v. United States*, 423 F. 2d 601 (1st Cir. 1970); *Estate of Cutter v. Commissioner*, 62 T.C. 351 (1974). Whether the exception applies for purposes of IRC Secs. 2036(a)(1) and 2038 where the retained power is exercisable in favor of the powerholder under an ascertainable standard is uncertain. Logically, the exception should apply, and Action on Decision 1981-101 (Apr. 14, 1981) says that it does, but there is no developed body of law.

[106] See, e.g., Uniform Trust Code Section 505.

retained by him, regardless of who created the trust. It seems likely that the same result would obtain if the settlor transferred only a small amount, such as $5,000, to the trust, as is contemplated in some uses of the BDIT.

If the beneficiary's transfer is a sale rather than a gift, does the result change? First suppose that the beneficiary sells property to the trust at a bargain price equal to half the property's fair market value. It seems that such a bargain sale would make it possible for the IRS to argue that the beneficiary remains the transferor and therefore that IRC Secs. 2036 and 2038 remain potentially applicable to the bargain sale. If that is so, then the IRS could make the same argument in the case of a sale for full and adequate consideration. Why should the payment of full consideration change the identity of the transferor? The proponents of the BDIT seem to maintain (though the point is not discussed explicitly) that if the sale is for full consideration, the property transferred to the trust by the beneficiary in the sale will be treated for estate tax purposes as if transferred by the trust settlor. That may be so, but for transfer tax purposes it is not clear that it is so, and the IRS may argue otherwise.

The grantor trust rules contain precise rules for determining who the transferor (grantor) is in the above examples. The beneficiary is treated as the grantor to the extent of any gratuitous transfer to the BDIT, and in the case of a bargain sale the value in excess of the sale price is treated as a gratuitous transfer. However, the beneficiary does not become the grantor in the case of a sale at fair market value.[107] However, these rules may not apply for transfer tax purposes. For example, as discussed in the next paragraph, in the case of a bargain sale IRC Secs. 2036 and 2038 include the entire value at death of the sold property, reduced by the consideration paid, rather than a portion of the property proportionate to the bargain element on the date of sale.

(4) Estate tax considerations because of potential application of IRC Secs. 2036 and/or 2038 with the $5,000 BDIT guaranteed sale technique.

Unlike a conventional sale to a grantor trust in which the seller does not have a retained interest or power over the trust, under the $5,000 BDIT Guaranteed Sale Technique, the seller is also a beneficiary of the BDIT and will have a retained interest or power, which will trigger IRC Secs. 2036 or 2038, unless an exception applies. Under the "parenthetical exception" contained in both IRC Sec. 2036 and IRC Sec. 2038, these provisions do not apply "in case of a bona fide sale for an adequate and full consideration in money or money's worth." If the exception applies, the property sold will be excluded from the beneficiary's gross estate despite the beneficiary's interests and powers under the BDIT. If the exception does not apply, the sold property is included in the beneficiary's gross estate at its date-of-death value, reduced by the consideration paid under IRC Sec. 2043.[108]

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[107] See Treas. Reg. Section 1.671-2(e), especially subparagraphs (1) and (2), and Ex. (7) under subparagraph (6).

[108] The parenthetical exception should also apply to a sale to a self-settled trust, so it may be asked what advantage the beneficiary grantor trust provides, other than a cosmetic one. One answer may be that the "creditors'

The application of the parenthetical exception under IRC Secs. 2036 and 2038 requires not only that the transfer be for "full consideration," but that it is "a bona fide sale". In the family partnership context, courts have held that the "full consideration" and "bona fide sale" requirements are two separate tests. The courts have also held that for a transfer to be a bona fide sale the transfer of assets to the partnership must have a significant nontax investment purpose.[109] Whether this requirement would apply to a sale under the $5,000 BDIT Guaranteed Sale Technique, and what it would mean in that context, are uncertain.

It seems essential that the sale be for full consideration for the BDIT to achieve its goal of keeping trust property out of the selling beneficiary's gross estate. As stated in one article: "The beneficiary must never make a gratuitous transfer to the trust."[110] This puts pressure both on the valuation of the transferred property and the valuation of any note taken in return. For instance, if an appropriate court finds that for estate tax purposes the sale to the BDIT was for inadequate consideration by even a small amount, all of the then value of the BDIT at the death of the beneficiary will be included in the beneficiary's estate under IRC Secs. 2036 and/or 2038, minus the value of the note (because of the operation of IRC Sec. 2043) at the time of the sale.

As a consequence, the beneficiary/seller should consider a defined value assignment and the filing of a gift tax return that discloses the sale. However, even if the sale is reported on a gift tax return that meets the adequate disclosure requirements of Treas. Reg. §301.6501(c)-1(f) and the gift tax statute of limitations runs, the IRS may not be barred upon the beneficiary's death from asserting "inadequacy of consideration" for purposes of IRC Sec. 2036 and 2038. Adequacy of consideration is a "valuation issue" rather than a "legal issue." Treas. Reg. §25.2504-2(c), Ex. (3). An estate tax regulation provides that for transfers after August 5, 1997, the running of the gift tax statute of limitations bars any adjustment to the value of a prior gift, and this rule "applies to adjustments involving all issues relating to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law." Treas. Reg. §20.2001-1(b). This regulation, applies "[f]or purposes of determining the amount of adjusted taxable gifts as defined in Sec. 2001(b)." Furthermore, determining inclusion under IRC Secs. 2036 and 2038 is not the same as determining the amount of adjusted taxable gifts and the regulation may not prevent revisiting the consideration question under IRC Secs. 2036 and 2038. The gift tax disclosure regulations do not specifically address finality on the issue of adequate consideration for purposes of IRC Secs. 2036 or 2038. They do address the case of an incomplete transfer reported as a completed transfer. Treas. Reg. §301.6501(c)-1(f) provides that "if an incomplete gift is reported as a completed gift on the gift tax return and is adequately disclosed, the period for assessment of the gift tax will begin to run when the return is filed, as

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rights" doctrine will apply more strictly to a self-settled trust, although if the requirements of the parenthetical exception are met, that may not matter.

[109] E.g., *Estate of Strangi v. Commissioner*, 417 F.3d 468 (5th Cir. 2005); *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005).

[110] Richard A. Oshins, Larry Brody & Katarinna McBride, *"The BDIT: A Powerful Wealth Planning Strategy When Properly Designed and Implemented,"* LISI *Estate Planning Newsletter* 1824 (June 22, 2011), at http://www.leimbergservices.com.

determined under Sec. 6501(b). Further, once the period of assessment for gift tax expires, the transfer will be subject to inclusion in the donor's gross estate for estate tax purposes only to the extent that a completed gift would be so included." The final sentence is ambiguous as applied to an attempt to invoke IRC Secs. 2036 and 2038 at death on the grounds that the transfer was not for full consideration, but the more convincing reading is that the regulation would not preclude inclusion of the transfer under those sections, because IRC Secs. 2036 and 2038 can apply to transfers which are completed gifts. Moreover, it is not clear that the regulation, which applies when "an incomplete gift is reported as a completed gift," will apply to a return that reports the transfer as a sale for full consideration but says nothing about whether any value later determined to be in excess of the consideration is a complete or incomplete gift. That is the way most such gift tax returns will read, because the beneficiary typically will want to preserve the "incompleteness" argument as to any gift if the consideration is found inadequate.

Furthermore, the gift tax return filing will not start the statute of limitations running on an estate tax issue of whether the sale is a "bona fide sale" because that is a legal issue, which may only be determined on the taxpayer's death. This may put pressure on the non-tax purpose of the sale. Like any sale, the non-tax purpose may be met if the taxpayer can demonstrate that there was a plausible risk/reward commercial relationship with respect to the sale and in that regard there was adequate security to demonstrate that the note had the characteristics of a note and not a deemed retained interest in the trust. Hopefully, on the taxpayer's death, it can be demonstrated that there was a high probability that the note would be paid in full, and, in fact, it was paid in full.

(5) Estate tax considerations if under applicable state law or federal bankruptcy law the seller/beneficiary's creditors can reach the BDIT assets under the $5,000 BDIT guaranteed sale technique.

Even if an assigning seller/beneficiary does not have any current creditors, or any future creditors, if the assigning seller/beneficiary *could* create a creditor relationship under which part or all of the trust assets, either under state law or federal bankruptcy law, would be available to satisfy that creditor obligation, that part or all of the trust will be included in the assigning seller/beneficiary's estate for estate tax purposes. Even if the sale is for adequate and full consideration for gift tax purposes, the IRS could take the position that either (i) the sale is not adequate for creditor protection purposes under the relevant state property law or (ii) even if the sale is adequate for state law purposes, the assigning seller/beneficiary, under certain assumptions, could still create a future creditor relationship that could access the trust. *See* discussion *infra* Section IX.A.4.h.

(6) If it is possible for a current or future creditor of an assigning seller/beneficiary to reach that part of the trust assets that are sold, then that part of the trust may not constitute a complete gift for gift tax purposes.

The IRS could argue that because of state property law, or federal bankruptcy law, the grantor/beneficiary could create a future creditor relationship, which would terminate part or all

of the trust. That power by the assigning seller/beneficiary would mean that the assigning seller/beneficiary has retained dominion and control over that part of the trust, and has not completed a gift for gift tax purposes under Treas. Reg. §25.2511-2(b).[111]

5. Income tax considerations with the $5,000 BDIT guaranteed sale technique.

a. In general.

The BDIT must remain a grantor trust during the beneficiary's life, or at least while any note is outstanding, in order to circumvent a capital gain on the sale (or as installments are paid), income tax on interest payments, and (possibly) adverse consequences upon loss of grantor trust status under Treas. Reg. §1.1001-2(c), Ex. (5). To achieve grantor trust status under IRC Sec. 678, initially the beneficiary must have over the trust "a power exercisable solely by himself to vest the corpus or the income therefrom in himself." IRC Sec. 678(a)(1). If left in place, such a power would cause the trust property to be includible in the beneficiary's gross estate under IRC Secs. 2036 and 2038, or under IRC Sec. 2041, whichever is viewed as applicable. Thus this power must be cut down before the beneficiary's death without either (1) losing grantor trust status, or (2) causing the beneficiary to be treated as the transferor for estate tax purposes.

Once the beneficiary acquires a power described in IRC Sec. 678(a)(1), IRC Sec. 678(a)(2) provides that the trust continues to be a grantor trust after the powerholder "has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of IRC Secs. 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof."

b. It is necessary for the settlor of the BDIT to steer clear of grantor trust status.

In order to achieve grantor trust status for the beneficiary of the BDIT under IRC Sec. 678, the trust cannot be a grantor trust to the settlor. In Private Letter Ruling 200949012, the IRS rules that the trust would not be a grantor trust as to the settlor, yet the beneficiary would be treated as the owner for income tax purposes under IRC Sec. 678. The design of the trust in that private letter ruling provides a great roadmap in avoiding grantor trust status for the settlor. The private letter ruling notes the following key facts:

> Grantor is not a beneficiary under the Trust, and has no interest under the Trust. Trust provides that no income or principal of Trust may be paid or appointed for the benefit of the Grantor or Grantor's spouse, or to pay premiums on insurance policies on the life of Grantor and/or Grantor's spouse. Trust further provides that neither Grantor nor Grantor's spouse may act as a Trustee of Trust and that no

[111] *See Outwin v. Commissioner*, 76 TC 153 (1981), acq. 1981-2 CB 1; *Herzog v. Commissioner*, 116 F.2d 591 (2d Cir. 1941).

more than one-half of Trustees of Trust may be related or subordinate parties to Grantor, within the meaning of § 672(c).

Trust further provides that Grantor does not intend to be treated under subpart E of Part I of subchapter J as the owner of Trust. Trust further provides that neither Grantor nor any other "nonadverse party" as that term is defined in § 672(b) shall have the power to (1) purchase, exchange or otherwise deal with or dispose of Trust's principal or income for less than adequate consideration or (2) borrow any of Trust's principal or income without adequate interest or security. Trust further provides that no person, other than a United States person, shall have the authority to control any substantial decision (within the meaning of § 7701(a)(30)(E) of any trust created under an [sic] held under Trust. No court, other than a court within the United States, shall exercise primary supervision over the administration of any trust created and held under Trust. Grantor and beneficiary represent that Trust will be a domestic trust within the meaning of § 301.7701-7 of the Procedure and Administration Regulations.

The private letter ruling concludes that based on the above facts the settlor will not be taxed under the grantor trust rules.

c. Release vs. lapse

One issue with respect to any BDIT in which there is a lapse of a withdrawal right, is whether IRC Sec. 678(a)(2) applies when the power is cut down by a lapse rather than a release. If a lapse occurs pursuant to the terms of the trust, can the powerholder be said to have "partially released or otherwise modified" the power? In two non-precedential private rulings issued in 2009 and 2010, the IRS has held that after a lapse the beneficiary continues to be taxable on the income of the trust under IRC Sec. 678(a)(2).[112] These are the latest in a long line of private rulings that treat a lapse as covered by the "partially released or otherwise modified" language of IRC Sec. 678(a)(2).[113] However, the rulings do not discuss in detail the issues underlying that result. Some worry that the rulings are questionable and the IRS could change its position because a lapse is different than a release, and IRC Sec. 678(2) does not mention lapses.[114] A "release" requires an act by the powerholder, while a "lapse" can occur pursuant to the terms of the trust without an affirmative act. Is a lapse a release or other modification as required by IRC Sec. 678(a)(2)? The private rulings imply that the answer is yes.[115]

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[112] *See* PLR 200949012 (Aug. 17, 2009); PLR 201039010 (June 29, 2010).

[113] See rulings cited in Howard Zaritsky, "*The Year in Review: An Estate Planner's Perspective on Recent Tax Developments,*" TM Estates Gifts and Trusts Journal (*BNA*) (Jan. 13, 2011).

[114] *See* Avi Kestenbaum, Jeff Galant & Eli Akhaven, "The Beneficiary Defective Inheritor's Trust: Is It Really Defective?," LISI *Estate Planning Newsletter 1730* (Dec. 14, 2010), at http://www.leimbergservices.com.

[115] Under the gift and estate tax, specific statutes provide that a lapse is a release. IRC Secs. 2514(e), 2041(b)(2). These provisions do not apply to the extent the lapsed power covered less than the greater of $5,000 or 5% of the trust's value.

d. Partial release or other modification

Assuming a lapse can qualify as a release or other modification, the next issue with respect to any BDIT in which there is a lapse of a withdrawal right is whether a power that has lapsed completely (either all at once or in stages over time) remains one described in IRC Sec. 678(a)(2), given the statute's requirement that the IRC Sec. 678(a)(1) power have been "partially released or otherwise modified" (underscoring added). For estate tax purposes, it would be desirable to eliminate the power of withdrawal entirely prior to death because, even if tested under IRC Sec. 2041, it is a general power. In Private Letter Ruling 201039010 withdrawal powers over successive additions lapsed completely (within the "5 & 5" limits) after each year's addition, but IRC Sec. 678(a)(2) was held to apply, without discussion of the word "partially" in the statute. One way to read IRC Sec. 678(a)(2) is that if the beneficiary once had a IRC Sec. 678(a)(1) power, IRC Sec. 678(a)(2) applies as long as the beneficiary has any continuing interest or power that would make a self-settled trust a grantor trust, even if the beneficiary no longer has any power to withdraw. The line of private rulings mentioned in the preceding paragraph supports this reading. The language of the pertinent Regulation seems also to support it.[116] This reading is not certain, however, and some practitioners would argue that the power to withdraw must continue to some extent for the lapse to be "partial".[117] The design of the trust described in Private Letter Ruling 200949012 finesses this issue, giving the beneficiary a continuing withdrawal power under an ascertainable standard, supporting the conclusion that there has been a "partial release" or other "modification" of the unlimited withdrawal power, rather than a complete release. Again, however, the ruling does not discuss the issue specifically.

E. A Substantially Funded BDIT Created By a Hanging Power Lapses in Another Substantially Funded BDIT.

1. What is the substantial lapsing hanging power created BDIT technique?

The settlor to a BDIT ("BDIT 1") could contribute a corpus that is much greater than $5,000. The BDIT 1 could be designed so that the original unlimited power to withdraw all of the assets of the trust gradually lapses over time pursuant to a so-called "hanging power." The trust assets with that unlimited power to withdraw could pass to another trust ("BDIT 2") in which the beneficiary only has the power to withdraw pursuant to an ascertainable standard. The technique may be illustrated by the example below:

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[116] Treas. Reg. Section 1.678(a)-1(a) states: "The holder of [an IRC Sec. 678(a)(1) power] also is treated as an owner of the trust even though he has partially released or otherwise modified the power so that he can no longer vest the corpus or income in himself, if he has retained such control of the trust as would, if retained by a grantor, subject the grantor to treatment as the owner under Secs. 671 to 677, inclusive." See Jeffrey A. Galant, "*Beneficiary Grantor Trusts: Overview of Selected Issues*," paper prepared for the ACTEC Business Planning Committee Summer 2011 Meeting.

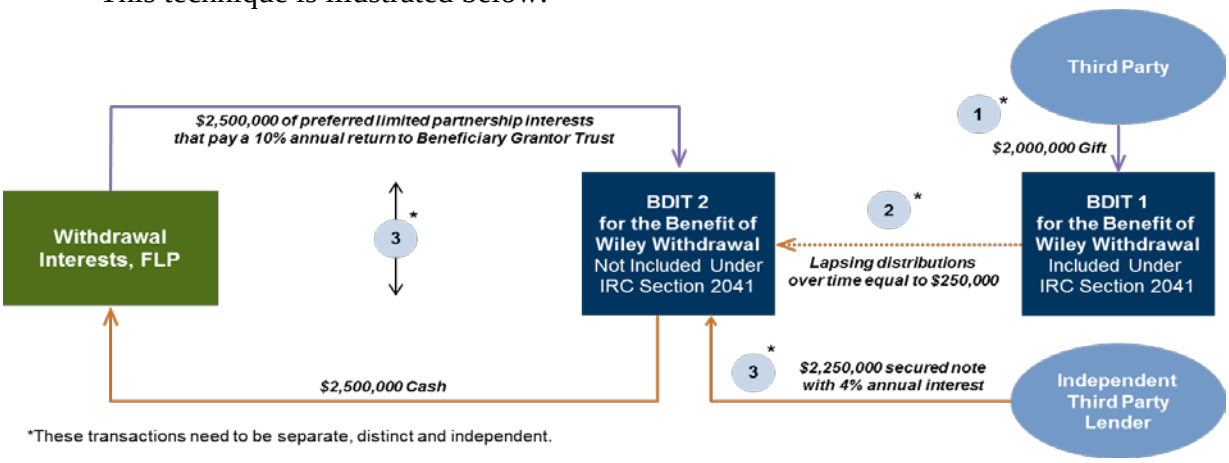
[117] Jonathan G. Blattmachr & Diana S. C. Zeydel, "PLR 200449012 – Beneficiary Defective Trust(sm) Private Letter Ruling," LISI *Estate Planning Newsletter* 1559 (Dec. 10, 2009), at http://www.leimbergservices.com.

Example 11: A BDIT is Created By a Third Party With Substantial Assets and Under Which There is Only a Gradual Lapse of the Unlimited Withdrawal Power

Wilhelmina Withdrawal creates a trust, BDIT 1, for the benefit of her son Wiley Withdrawal. She contributes $1,000,000 to the trust. Wiley has an unlimited power of withdrawal of $1,000,000 for any reason, which gradually lapses over time (this lapsing power annually lapses by the greater of 5% of the value of the assets or $5,000.00). Each year when the unlimited power to withdraw $1,000,000 partially lapses, the trust assets equal to that lapse are held in another trust, BDIT 2, in which Wiley Withdrawal has a direct or indirect limited power of withdrawal that never lapses and that limited power of withdrawal is tied to an ascertainable standard relating to Wiley's health, support and maintenance. Wiley lives in a state where his creditors cannot reach the assets of a trust that is not included in his estate under IRC Sec. 2041 despite his powers of withdrawal.

Five years later, the trust in which Wiley has a limited power of withdrawal (BDIT 2) has $250,000 in it. That trust then borrows $2,250,000 from an independent third party and invests $2,500,000 in Withdrawal Interests, FLP and receives a preferred limited partnership interest that pays a 10% coupon and has certain put rights.

This technique is illustrated below:



2. Advantages of the substantial lapsing hanging power created BDIT technique.

a. Transfer tax advantage.

The use of a reverse freeze (using high yielding preferred partnerships) has been explored by this writer and others.[118] A high yielding preferred partnership interest may make excellent collateral to an independent third party lender. Assuming the trust is not taxable in Wiley's

[118] *See* this author's paper, "Some of the Best Family Limited Partnership Ideas We See Out There," ALI-ABA Planning Techniques for Large Estates, at 167-82 (Nov. 5, 2010); *see also* the discussion in Section V of this paper.

estate, any future sales into the trust in which Wiley has a limited power of withdrawal should not be subject to capital gains taxes. The trust, as described above, would have considerable flexibility for Wiley's cash flow needs. Assuming Wiley has a limited power of appointment over the trust he should be able to reallocate the corpus of the trust if he has different stewardship goals at the time of his death. In the initial year, the trust has $250,000 in free cash flow to pay to the third party lender.

Over time, as the note is paid down, and also over time as more assets are available to the trustee because of future lapsing distributions to BDIT 2, greater equity will exist in the trust. This equity could support subordinated note sales of other assets (e.g., preferred partnership interests) by Wiley Withdrawal. All of this could be done without the necessity of guarantee fees or sales of remainder interests in GRATs. There is much more transfer tax substance to the leverage of this technique than the techniques discussed in Examples 10 and 12. Furthermore the leverage is coming from an independent third party lender instead of the transferor/beneficiary of the BDIT.

b. It has the same income tax advantages as the SIDGT technique.

See supra Section III.B.

3. Considerations of the substantial lapsing hanging power created BDIT technique.

a. Use of a BDIT raises many of the income tax issues discussed *supra* Section IX.D.5.

b. IRC Sec. 2041 issues.

If the beneficiary should die in the early years of the trust, a substantial portion of the original trust, which is subject to IRC Sec. 2041, will be included in his estate because of the unlimited power to withdraw assets to the extent the unlimited power to withdraw assets is still in existence.

c. Use of a third party lender.

This technique may also require the existence of an asset that is attractive as security to a third party lender, because a third party will demand collateral that has substantial inherent cash flow and safety. A high yielding preferred partnership interest, in which the other assets of the partnership are subordinated to the preferred partnership interest, may be such an asset.

d. Pecuniary withdrawal right issues.

This use of the BDIT, in which there is a lapse of a withdrawal right, calls for the settlor to contribute to the trust property with a value greater than $5,000, so that the beneficiary's

power of withdrawal cannot lapse in full at the end of the first year and must lapse over time as a "hanging power".[119] Assuming the trust appreciates in value, the power may lapse faster if it is defined as a pecuniary amount, because the appreciation will increase the potential annual lapse without increasing the amount withdrawable under the power. However, this raises another IRC Sec. 678 consideration: whether the trust could lose its status as a wholly grantor trust in a year in which, because of appreciation in the value of the trust, the pecuniary amount withdrawable under IRC Sec. 678(a)(1), plus the portion of the trust subject to IRC Sec. 678(a)(2) by reason of prior lapses, totals less than the current value of the trust. Under Treas. Reg. §1.671-3(a)(3), the IRS could also argue that the portion of the trust represented by such excess appreciation is not currently subject to the grantor trust rules, so the BDIT is no longer wholly a grantor trust. Moreover, in the absence of subsequent depreciation, it seems that the portion not subject to IRC Sec. 678(a)(1) can never become subject to IRC Sec. 678(a)(2), so that the trust never again becomes wholly grantor, although some argue otherwise.[120]

For example, if the trust assets initially covered by the withdrawal power is X where X equals the entire value of the trust, but in a future year the trust is worth 4X, the portion of the trust considered to be a grantor trust under IRC Sec. 678 in that year may be 25%. Moreover, if the power then lapses each year to the extent of 5% of the value of the trust per year, assuming no further appreciation or depreciation, the maximum portion of the trust that will eventually consist of property over which a power of withdrawal lapsed will also be 25%, and the trust never again becomes wholly grantor. Obviously, if that is the correct interpretation, the servicing of any note from a sale by a beneficiary to the trust would be disadvantageous to the extent a trust is treated as a complex trust instead of a grantor trust. The IRS has never taken this approach in its private letter rulings regarding trusts that qualify to be Subchapter S shareholders because they are grantor trusts.[121] Otherwise, if the trusts were not wholly grantor trusts, they might not have qualified as Subchapter S trusts.

One solution to the problem discussed in the preceding paragraphs may be to initially define the beneficiary's withdrawal right as extending not to a pecuniary amount but to 100% of the trust property, lapsing each year as to 5% of the trust (or such greater percentage as equals $5,000 in value). This will require more time for the power to lapse completely.

It should be noted that some practitioners believe that the "portion" rule of Treas. Reg. §1.671-3(a)(3) does not apply when the beneficiary's pecuniary power of withdrawal is large enough to make all property added to the trust withdrawable, even if subsequent appreciation or

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[119] The annual lapse of the power of withdrawal will be limited to the greater of $5,000 or 5% of the value of the trust, to keep the Beneficiary from being treated under IRC Sec. 2041 as a transferor for gift and estate tax purposes by reason of the lapse. As mentioned above, this requires that the governing law must protect such a lapse from creditors' rights, which is the case under Uniform Trust Code Section 505(b)(2).

[120] Jonathan G. Blattmachr & Diana S. C. Zeydel, "PLR 200449012 – Beneficiary Defective Trust(sm) Private Letter Ruling," LISI *Estate Planning Newsletter* 1559 (Dec. 10, 2009), at http://www.leimbergservices.com.

[121] For example, *see* PLR 200011058 (Dec. 15, 1999); PLR 200011054 to 056 (Dec. 15, 1999); PLR 199942037 (June 7, 1999); PLR 199935046 (June 7, 1999).

income accumulation increases the trust's value above the pecuniary amount. In such a case, all value in the trust is attributable to property over which the beneficiary once had a power of withdrawal. The beneficiary could have captured all the increasing value for himself by promptly exercising the power, but instead allowed it to "lapse" as to such value. Therefore it can be argued that any value that is no longer withdrawable is covered, at least in a policy sense, by IRC Sec. 678(a)(2).[122]

F. The Technique of a $5,000 BDIT Purchasing the Remainder Interest in a GRAT or a LAGRAT (the "BDIT Remainder Purchase Technique").

1. What is the BDIT remainder purchase technique?

A third party could create a trust for the benefit of the potential seller to the trust. The trust could be designed so that the third party settlor is not taxable on the trust income under the grantor trust rules. The trust could also be designed so that the beneficiary has an unlimited right to withdraw of all of the assets that are in the trust for a period of time. The right of withdrawal lapses after a period of time, (e.g., one year) in an amount equal to the greater of 5% of the value of the corpus of the trust or $5,000. However, the beneficiary could also be given the direct or indirect right to continue to withdraw income and principal of the assets of the trust, as long as it is for the beneficiary's health, education, support or maintenance as described under IRC Sec. 2041. The situs of the trust is in a jurisdiction in which a lapse of the greater of 5% of the corpus or $5,000 does not give a creditor rights to the trust (hereinafter the trust is referred to as a "BDIT"). The beneficiary/transferor could sell certain assets to the BDIT, either using the LAGRAT technique in which the BDIT trustee pays for the remainder interest (which is the technique explored below), a sale for a note that is guaranteed by another trust, or a sale to the BDIT that is financed by an independent third party lender. The beneficiary/transferor is considered the owner of the trust for income tax purposes under IRC Sec. 678.

Consider the following example:

Example 12: Creation of a LAGRAT in Which the BDIT Remainderman Pays Full Consideration For That Remainder Interest

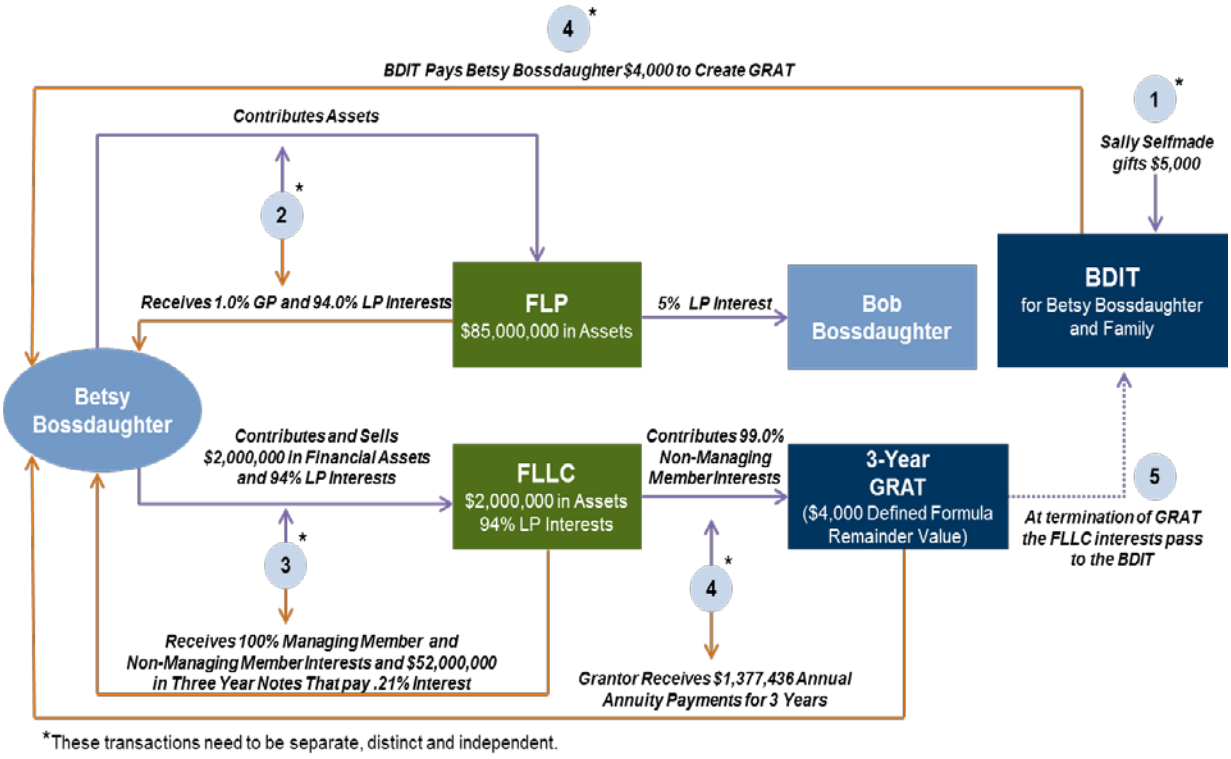
Betsy Bossdaughter has $97,000,000 in financial and private equity assets. Betsy wishes to maintain maximum flexibility in her estate planning. Betsy also wishes to retain the right to change her mind as to future stewardship goals and consumption needs. Betsy's husband, Bob owns $5,000,000 in assets. Assume that Betsy and Bob's assets will grow at 7.4% a year pre-tax. Betsy's mother, Sally Selfmade, is still living. Sally is going to create a generation-skipping trust for the benefit of Betsy. The trust will have a corpus of $5,000 (Transaction 1 below). The trust agreement will provide that Betsy has the right to withdraw all the trust assets for a year. That

[122] Steven B. Gorin, "*Beneficiary Grantor Trusts: A New Paradigm for Transferring Businesses*," paper prepared for the ACTEC Business Planning Committee Summer 2011 Meeting, pp. 14-15; see also Jeffrey A. Galant, "*Beneficiary Grantor Trusts: Overview of Selected Issues*," paper prepared for the ACTEC Business Planning Committee Summer 2011 Meeting, section A(2).

right lapses after a year. After the first year, Betsy will also have the power to withdraw the trust assets as needed for her health, support and maintenance in order to maintain her standard of living. That right will not lapse. In a separate and distinct transaction, after Sally creates the $5,000 trust, the trustee of the trust transfers $4,000 of the trust to Betsy for full consideration for Betsy creating a GRAT, with the assets described below, that has a $4,000 defined value remainder interest (Transaction 4 below).

The GRAT is funded with non-managing member interests in a FLLC that was funded with limited partnership interests in a FLP, as illustrated below (Transactions 2 and 3 below). It is assumed that valuation discounts for transfers of the limited partnership interests and the non-managing member interests of the FLLC are each equal to 30%. It is assumed that the IRC Sec. 7520 rate is 1.0%.

This technique is illustrated below:



2. Advantages of the BDIT remainder purchase technique.

   a. The assets of the BDIT, if the transferor is not a deemed donor under equitable principles, will not be subject to estate taxes in the transferor's estate.

See discussion *supra* Section IX.D.3. Under the assumed facts, if Betsy is not a transferor, or a deemed transferor under equitable principles, the BDIT assets may not be taxable in the beneficiary's estate. The lapsed withdrawal power meets the exception of IRC Sec. 2041.

Obviously, if this technique is successful, it could be a very powerful technique with respect to estate planning for Betsy Bossdaughter and her family. Please see the following chart, which denotes what the estate taxes would be at the end of five years, 15 years and 30 years (also see the spreadsheets attached as Schedule 10):

Table 6

Hypothetical Results	Assuming Mr. and Mrs. Bossdaughter Die at the End of 5 Years	Assuming Mr. and Mrs. Bossdaughter Die at the End of 15 Years	Assuming Mr. and Mrs. Bossdaughter Die at the End of 30 Years
Estate Taxes at 40%			
No Further Planning; Bequeaths Estate to Family (assumes $25.5mm estate tax exemption available)	$44,243,250	$61,859,403	$102,572,795
Third Party Gift to a Trust in Which the Beneficiary is Taxed Under 678 but not Taxable in the Beneficiary's Estate (678 Trust); Creation of a Single Member FLLC with Contribution of Non-Managing Member Interests to a 3-Year GRAT in Which There is No Gift Because of a Purchase by the 678 Trust; the GRAT Remaindermen is a 678 Trust Created for the Benefit of the Grantor and His Family; Bequeaths Estate to Family (assumes $25.5mm exemption is available)	$23,651,853	$16,164,598	$0

b. It has the same income tax advantages as the LAGRAT technique.

See the discussion *supra* Section VII.B.

c. Has the advantage of allowing Betsy access to cash flow from note payments, and as a beneficiary of the BDIT.

If the transaction is successful, during the term of the GRAT, the grantor of the GRAT will have access to the cash flow of the assets of the FLLC, either through the note payments from the FLLC, or the annuity payments from the GRAT. After the GRAT terminates, the transferor will have access to the cash flow of the assets of the FLLC either from the note payments of the FLLC, or under the terms of the BDIT, if the cash flow of the BDIT is needed for her support and maintenance.

d. The transferor has flexibility to change the future beneficiaries of the trust through the exercise of a special power of appointment.

If the transferor has a power of appointment over the BDIT the taxpayer also has the flexibility of redirecting the assets in a manner that may be different than the default provisions of the trust document.

e. Has the potential of avoiding gift tax surprises.

The GRAT can be designed with a built-in revaluation clause. If the IRS disputes any valuation discounts associated with the FLLC, because of the built-in revaluation clause the

annuity amounts accruing back to the taxpayer would increase. Such a clause should not be against public policy and, in fact, is explicitly permitted by the IRS regulations. Treas. Reg. §25.2702-3(b)(1)(ii)(B).

f. Appreciation will be out of the transferor's estate.

To the extent the assets of the FLLC increase in value above the interest carry on the note and the annuity payments that accrued back to the transferor, that appreciation should be out of the transferor's estate, assuming the transaction is recognized for estate and gift tax purposes.

3. Considerations of the BDIT remainder purchase technique.

a. In order for the full and adequate consideration exception under IRC Sec. 2036 to apply, the remainder interest of the GRAT that is sold may need to have a substantive value much greater than $4,000.

There are three Circuit court cases providing that IRC Sec. 2036 does not apply when there has been full and adequate consideration for a sale of a remainder interest in a trust.[123] However, in each of those case there was a substantial remainder interest (much greater than $4,000). Query: would the courts be reluctant to provide that adequate and full consideration exists to circumvent application of IRC Sec. 2036 in a situation in which only $4,000 is paid in the context of a multi-million dollar trust? Stated differently, with the significant leverage involved in the creation of a FLLC, and the significant leverage involved in creating a GRAT, would a court take the view that the leverage is too extreme and that the *substance* of the transaction is a transfer of the FLLC interests by the beneficiary/transferor to the BDIT for less than full consideration? A court could take the position that those cited cases are all distinguishable because the purchase of the remainder interest in each of those cases had economic risk for the purchaser of the remainder interest. Under the Sam and Sally facts, the economic exposure of the BDIT resulting from its purchase of the GRAT remainder is $4,000. In the context of a multi-million dollar GRAT, a court may conclude that the remainderman trust's (i.e., the BDIT's) economic risk in the transaction lacks substance in comparison to the potential reward. In *Strangi*, the full Tax Court and the Fifth Circuit both concluded that IRC Sec. 2036 applies to any and all transfers, even if gift taxes are not owed on that transfer by that transferor.[124] If the remainder trust purchase had substance (perhaps because it is a spousal grantor trust that pays considerable consideration) IRC Sec. 2036 should not apply. But a court may find that is not the case under these facts. If the purchase of the remainder is not a "bona fide sale for an adequate and full consideration" IRC Sec. 2036 and/or 2038 could apply. The GRAT formula clause, unless easy to value assets are used or the GRAT and the BDIT have

[123] *See Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997); *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309 (3rd Cir. 1996); *Estate of Magnin v. Commissioner*, 183 F.3d 1074 (9th Cir. 1999); *contra*, *Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990).

[124] *See Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), aff'd, 417 F.3d 468 (5th Cir. 2005).

proportionate interests in the same entity, does not ensure that the consideration paid will equal the value of the remainder interest if values are increased on audit, because the remainder will increased proportionally and exceed the original payment. It may be possible to solve this problem by having the BDIT "overpay" for the remainder, which the trustee would have a rational reason to do to insure against later depletion of the trust assets by the beneficiary's estate tax apportioned to the trust, or by using a defined value clause for the sale, with any remainder value in excess of the sale price passing by gift to a recipient other than the BDIT.

b. Need to file a federal gift tax return.

See discussions *supra* Section IX.A.3.

c. State income tax considerations.

There may be state income tax considerations on the sale of any appreciated assets to the FLLC. There also may be state income tax consequences in selling the remainder interest of a GRAT to the BDIT.

d. Step transaction doctrine could apply.

Please *see* discussion *supra* Section IX.A.3. If the IRS can demonstrate, because of the thin capitalization, the $4,000 payment should be ignored, then under other equitable principles it may be able to establish the creation of the BDIT lacks independence, and the deemed grantor of the trust will be the beneficiary.

e. Creditor rights and related estate tax issues.

If the sale to a FLLC and the creation of the GRAT with the FLLC interests in consideration for a $4,000 payment from the BDIT is not for adequate and full consideration, then under the laws of the state of the beneficiary, the creditors may be able to reach whatever interest the beneficiary of the trust could distribute to himself or herself, and whatever the trustee could distribute to the beneficiary. A settlor's ability to redirect to creditors may include that portion of the trust in the beneficiary's estate under either IRC Sec. 2036 or IRC Sec. 2038. *See* discussion *supra* Section IX.A.3. The lapse of a power over not more than the greater of 5% or $5,000 does not cause the powerholder to be treated as a settlor of the property subject to the lapse under the laws of many states.[125] Here, however, the beneficiary's transfer of the remainder interest to the trust may make him a settlor for creditors' rights purposes despite those statutes, as his continuing interests and powers in the BDIT arguably result from the beneficiary's own transfer, rather than from the lapse of his unlimited power of withdrawal.

f. Incomplete gift issues.

See discussion *supra* Section IX.A.3.

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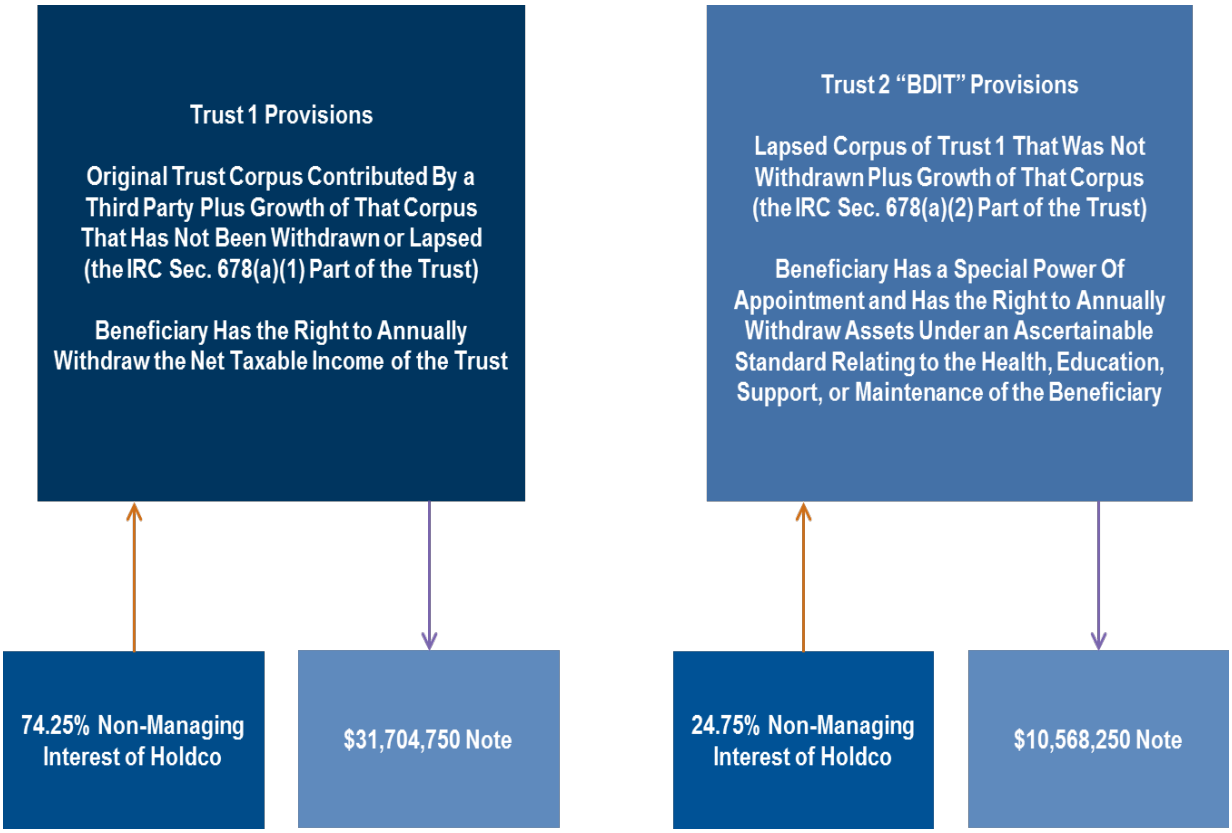
[125] *See* Uniform Trust Code Section 505(b)(1) and the comments under it.

G. Creation of and Additions to a BDIT Could Accrue By Providing That the Withdrawable, But Untaken, Funds of the BDOT, That Do Not Exceed 5% Corpus Limitation, Are to Be Held Under Trust Provisions Similar to BDIT Provisions After Each Lapse of the Withdrawal Power of the BDOT (the "BDOT Created BDIT").

1. What is the BDOT created BDIT technique.

See supra Section IX.C for a discussion of the BDOT technique, its advantages, considerations and an example of the technique. Under the facts of that Example 11, assume that after a period of time 25% of the net funds and the net corpus of the BDOT that is subject to the debt of the BDOT and that could have been withdrawn has not been withdrawn and has lapsed. That lapsed part of the trust could be held under different provisions of the trust that allow the beneficiary to only withdraw that part of the trust pursuant to an ascertainable standard relating to the health, education, support, or maintenance of the beneficiary. The beneficiary continues to have a testamentary special power of appointment. The technique is illustrated below:



2. Advantages of the BDOT created BDIT technique.

a. A BDIT created in this fashion has all of the advantages that may exist with a BDIT, including the advantage that the "Trust 2" part of the trust will be treated under IRC Sec. 678(a)(2) as a grantor trust to the beneficiary.

See the discussion *supra* Section IX.D.3.

b. This technique does not require the use of guarantees to support the integrity of the note that may lack substance under equitable tax principles.

See the discussion *supra* Section IX.D.3.

c. Since there is a much better chance the retained note of the seller to the trust, who is also a beneficiary of the trust, will be treated as a bonafide note there is less IRC Secs. 2036 and 2038 risk with the technique than a BDIT that is only created with $5,000.

d. There may be greater creditor protection under the above Trust 2 provisions than the Trust 1 provisions.

3. Considerations of the BDOT created BDIT technique.

a. Depending on how the lapse of the withdrawal power is implemented there could be the consideration that part of the trust may not be considered a grantor trust.

See the discussion *supra* Section IX.E.3.

b. A beneficiary has the automatic right to access the income and principal of Trust 1, which, under the terms of the agreement, is not the case for Trust 2.

However, under certain circumstances (e.g., concerns about creditors) that consideration could be an advantage. Secondly, assuming the beneficiary has a fairly wide-open special power of appointment, and is trustee of Trust 2, the payment of principal or income from Trust 2 to the beneficiary will probably not be considered by a remainder beneficiary to be an abuse of the HEMS standard for fairly obvious practical reasons. If the BDOT beneficiary does not withdraw net taxable income in a year, he loses the right to withdraw the income on that income in subsequent years. Does that threaten the idea that as to the BDOT he has the right to withdraw all the net taxable income?

X. USE OF A NON-GRANTOR TRUST, UNDER CERTAIN CIRCUMSTANCES, TO SAVE FEDERAL AND/OR STATE INCOME TAXES.

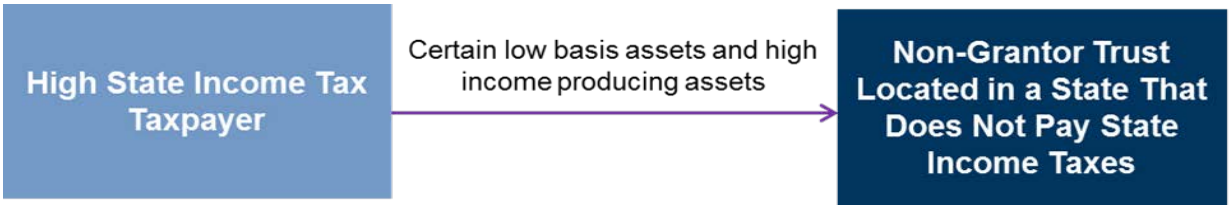
While the top bracket for non-grantor trusts starts at a relatively low level (approximately $12,500), there are circumstances in which non-grantor trust can save income taxes because that non-grantor trust may have deductions available to it that the beneficiaries of the non-grantor trust may not have available. Gifts and loans to a non-grantor trust can be a great estate planning tool, if the assets of the non-grantor trust grow above any interest carry that may exist. Under the circumstances noted below, a non-grantor trust can also be an income tax savings tool.

A. Using a Non-Grantor Trust to Save State Income Taxes.

Obviously, some states have much higher income tax rates than other states. Eight states do not have any state income taxes. Several more states do not subject income accumulated in non-grantor trusts that are created in those states to their state income taxes. The problem of high state income taxes could be particularly acute, if the taxpayer anticipates that sometime in the future he may sell some valuable low basis assets.

1. The technique.

A taxpayer who lives in a high income tax state may have low basis assets that he anticipates may be sold in the near future. That taxpayer may also have income producing securities from which he does not need that income for his consumption needs. That taxpayer could transfer those assets to a non-grantor trust whose situs is in a state that does not have any state income taxes on the income earned and accumulated by those trust assets. See a diagram of the technique below:



2. Advantages of the technique.

a. Substantial state income taxes could be saved.

b. The taxpayer using his or her increased gift tax exemptions could create a non-grantor trust in a state that does not tax that trust income, which could save income taxes and transfer taxes.

c. A non-grantor trust used for these purposes could be created without paying gift taxes: by the use of the taxpayer's exemption; by creating a trust that is incomplete for gift tax purposes; or by creating a martial deduction trust that qualifies as a QTIP trust and

is designed to be a non-grantor trust with respect to the principal earnings of the QTIP trust.

d. There could be multiple non-grantor trusts subject to the discussion *infra* Section X.E.

3. Considerations of the technique.

See the discussion *infra* Section X.E.

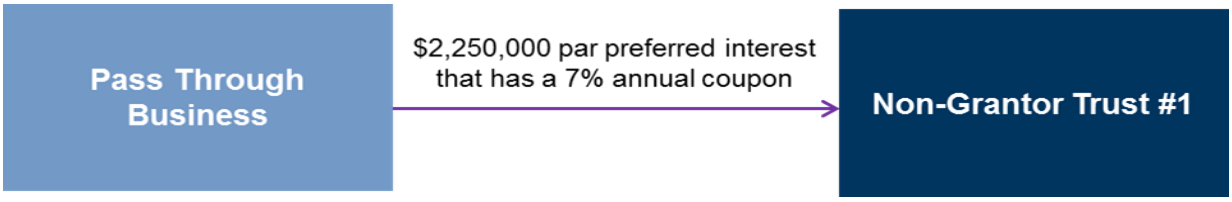
B. Using the Combination of Multiple Non-Grantor Trusts and Preferred Interests in Pass Through Businesses, to Save Federal Income Taxes By Using the Deduction Under IRC Sec. 199A, Which Otherwise Would Not Be Available.

1. The technique.

If a non-grantor trust has an interest in a pass through business and has an amount of taxable income below the 32% bracket (which is currently $157,500) that non-grantor trust will receive a 20% deduction on the amount of the qualified business income ("QBI") allocated to the trust. This is true, even if the income comes from a service business that would not otherwise qualify as qualified business income, the income is subject to the W-2 wages limit under IRC Sec. 199A(b)(2)(B)(i), or the income is subject to the W-2 wages and property limit under IRC Sec. 199A(b)(2)(B)(ii).

In order to manage the amount of QBI allocated to the non-grantor trust, the non-grantor trust's interest in the business could be a preferred interest with the coupon being equal to $157,500 in the first year with an increase each year in the par value of the preferred interest equal to the inflation adjustment that determines the 32% bracket. For example, a business owner of a pass through business gifts to a non-grantor trust a preferred interest in his pass through business that has a par value of $2,250,000 that pays a 7% coupon on that par value or $157,500. The par value of the preferred interest could be designed to increase at the same percentage rate as the 32% bracket increases. A tool to keep the taxable income at that $157,500 threshold amount is for the trustee to invest in assets, other than its business interest, that do not produce any, or very little, taxable income (e.g., municipal bonds or non-dividend paying stocks). If a non-grantor trust's taxable income before the QBI deduction is between $157,501 and $207,499, that estate or trust will be subject to the phase in limit rules of IRC Sec. 199A(b)(3)(B) and the phase-out rules for specified service trades or businesses contained in IRC Sec. 199A(d)(3).

Please see the diagram of the example below:



2. Advantages of the technique.

a. The technique lowers the family's income taxes associated with the family business.

b. There could be multiple non-grantor trusts, subject to discussion *infra* Section X.E.

c. For many families there should not be any gift taxes associated with the gifts to the non-grantor trusts, either because of the increased exemption, or because the non-grantor trusts are designed to be an incomplete gift (a so-called "ING trust").

d. Because of Revenue Ruling 83-120, if a preferred interest is used, the yield can be relatively high in comparison to the then prevailing interest rates, without causing gift tax consequences. See the discussion *infra* Sections XI.B and XII.B.

3. Considerations of the technique.

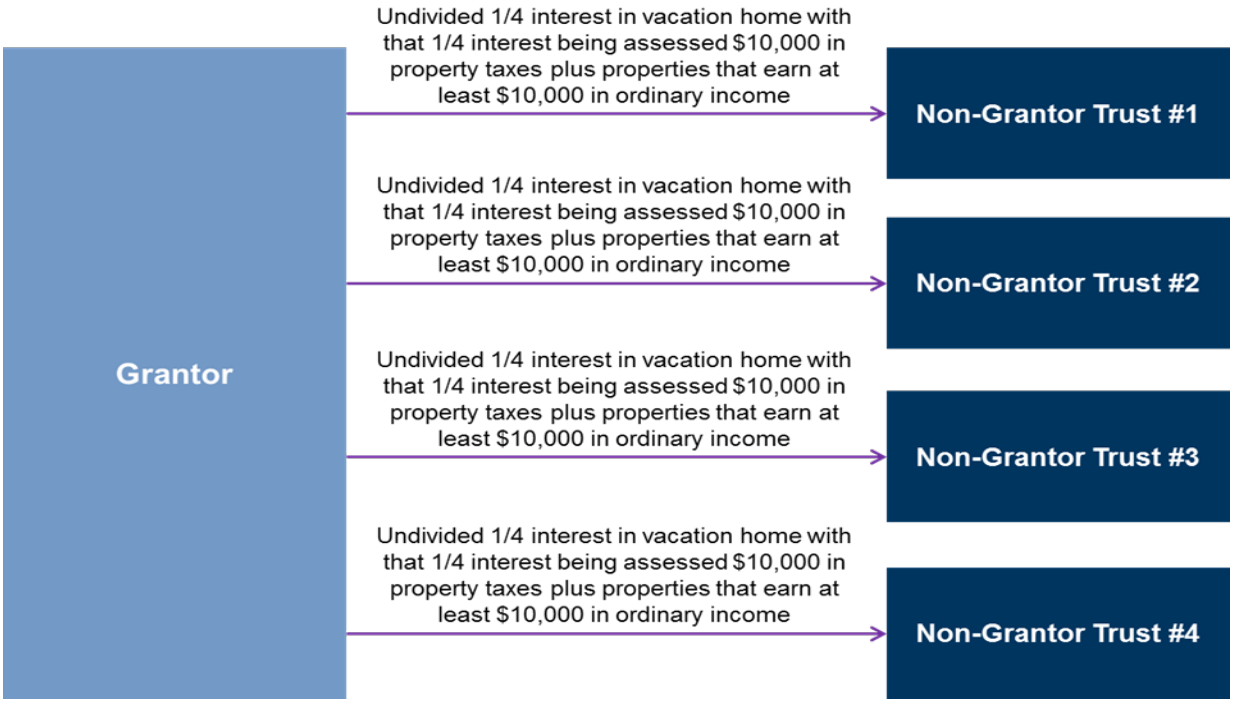
See the discussion *infra* Section X.E.

C. Using Multiple Non-Grantor Trusts to Multiply the $10,000 Capped Deduction for Property Taxes.

1. The technique.

An owner of real estate may split his or her ownership of the real estate into multiple undivided interests and contribute each of those undivided interests, along with ordinary income producing property, to different non-grantor trusts assuming each of those non-grantor trusts has at least $10,000 of ordinary income the $10,000 capped deduction for property taxes can be used for each new non-grantor trust.

Please see an example of the technique below:



2. Advantages of the technique.

This technique has the same advantages as using non-grantor trusts to save state income taxes. See discussion *supra* Section X.A.2. In addition, for many taxpayers, the complexity of creating an ING trust may not be necessary. The object of this technique is to save federal income taxes, not state income taxes. Assuming the taxable income of the trusts is basically at a break-even amount, the state income tax issues should be insignificant.

3. Considerations of the technique.

See the discussion *infra* Section X.E. An additional consideration with this technique is that in some states there exist real estate transfer taxes and/or gift taxes. Another consideration unique to this technique is that it is not clear what the IRS position will be with respect to the allowance of multiple capped deductions, if a taxpayer does not make a completed gift to several trusts.

D. Using Multiple Non-Grantor Trusts to Multiply the $10,000,000 Deduction From Capital Gains Taxes for Sales of Qualified Small Business Stock ("QSBS").

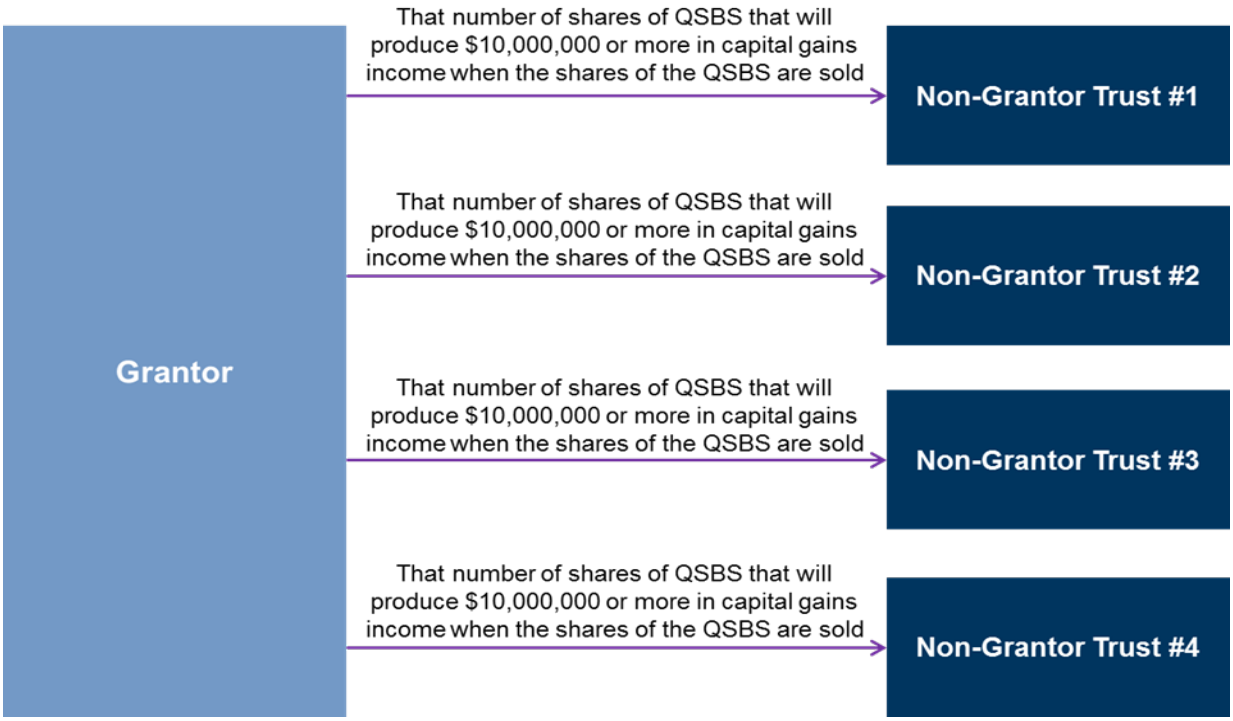
1. The technique.

An owner of shares of QSBS, as defined in IRC Sec. 1202(c), could give shares of his QSBS stock to multiple non-grantor trusts in order to receive multiple $10,000,000 deductions under IRC Sec. 1202(b)(1)(A) from the capital gains tax for the collective sale of that stock. If a C corporation meets the requirements of being QSBS and is held for more than five years, all of the inherent capital gains will be excluded subject to the greater of two statutory limits. One of

those limits is 10 times the adjusted basis of the QSBS issued by such corporation and disposed of by the taxpayer during the taxable year. With respect to this limit the adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued. See IRC Sec. 1202(b)(1)(B). For many owners of shares in a QSBS this limitation may be significant because of the modest basis a start up business may have.

However, the other limit found in IRC Sec. 1202(b)(1)(A) in many circumstances is much more generous. This limitation is equal to $10,000,000, regardless of the taxpayer's basis in the QSBS stock, reduced by the aggregate amount of eligible gain taken into account by the taxpayer for prior taxable years and attributable to dispositions of stock issued by the corporation.

Please see an example of the technique below:



2. Advantages of the technique.

This technique has the same advantages as using non-grantor trusts to save state income taxes. See discussion *infra* Section X.A.

3. Considerations of the technique.

See the discussion *infra* Section X.E.

E. Considerations With Creating Multiple Non-Grantor Trusts.

1. Either by the IRS applying future final IRC Sec. 643(f) regulations (which could be issued by Treasury in the near future), or by the IRS using equitable tax principles such as "substance over form," two or more non-grantor trusts could be treated as one non-grantor trust.

Proposed regulations under IRC Sec. 643(f) were issued on August 8, 2018. Given the advantages of multiple non-grantor trusts, which could affect federal revenues (*see supra* Section X.B, C and D), it should be anticipated that Treasury will issue final regulations in the near future to make IRC Sec. 643(f) an effective statute. Those final regulations, or equitable tax doctrines, may treat two or more non-grantor trusts as one non-grantor trust, if taxpayers use multiple non-grantor trusts that have substantially the same grantor, or grantors, and have substantially the same primary beneficiary, or beneficiaries, with the principal purpose of avoiding income taxes. Spouses are treated as one person under the proposed regulations.

However, under the proposed regulations, if there are significant non-tax differences between the substantive terms of the trusts, the trusts will not be treated as one trust. It would appear that a grantor could create a separate non-grantor trust for each one of his descendants and not run afoul of future regulations under IRC Sec. 643(f), or equitable tax principles. It may also be possible for a grantor to design two non-grantor trusts for each descendant if one of the non-grantor trusts is a completed gift trust and the other non-grantor trust is a non-completed gift trust. The key under the proposed regulations is that there be "significant non-tax differences between the substantive terms" of the trusts. *See* proposed Treasury Regulation §1.643(f)(1)(c) Example 2. Thus, for many families, depending on the number of descendants, it may be possible for several non-grantor trusts to be created.

2. It is difficult to design a non-grantor, incomplete gift trust (sometimes referred to herein as "ING trust").

While the ING trust must be designed carefully to provide that the grantor does not retain powers over the trust for income tax purposes that would make it a grantor trust under IRC Secs. 671-677, the ING trust must also be carefully designed to provide that the grantor of that trust has enough retained powers over the ING trust to make the creation of the trust incomplete for gift tax purposes.

Currently, a popular design of such a trust provides that the trust will be irrevocable; during the existence of the trust all distributions of income and principal may be made by the trustee to the grantor and/or the grantor's issue, but solely at the direction of a distribution committee; the distribution committee consists of the grantor and several of his issue and functions in a non-fiduciary capacity; decisions of the distribution committee may be executed either by the grantor and a majority of the other members of the distribution committee, or unanimously by all members other than the grantor; the grantor retains a power of appointment over the remainder of the trust; and the grantor retains the sole power to make trust distributions from trust principal under a reasonably definite standard for the health, education and support of his issue.

a. The grantor of the ING trust must not retain controls that trigger grantor trust status.

(1) The power to control beneficial enjoyment under IRC Sec. 674, the power to revoke the trust and reinvest trust property under IRC Sec. 676, and the power to distribute income for the benefit of the grantor or the grantor's spouse under IRC Sec. 677, all will not exist, if the grantor's power is only exercisable with an adverse party's approval.

An adverse party is defined under IRC Sec. 672(a) as "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power." Thus, if potential beneficiaries are members of a distribution committee, that is designed as noted above, IRC Secs. 674, 676 and 677 should not be available to make the trust a grantor trust, unless Treas. Reg. §1.677(a)-1(d) applies. Under that regulation a trust is a grantor trust under IRC Sec. 677, even if an adverse party exists, if its income is applied, or may be applied at the discretion of the trustee, or must be applied by the trustee to discharge the debts of the settlor, or the settlor's spouse. As a consequence, a self-settled trust, that is located in a state where the common law rules apply to allow creditors to reach trust assets created for the grantors own benefit, despite the presence of a spendthrift clause, will be deemed a grantor trust in those states. However, there exist 16 states where those common law rules do not apply (those states are sometimes referred to as Domestic Asset Protection Trusts or "DAPTs") and spendthrift provisions of trusts located in those states may prevent grantor trust status applying under IRC Sec. 677. It should be noted, however, that because of developing creditor protection law, creditor protection may be in some doubt for residents of common law states creating trusts subject to the laws of DAPT states. It should also be noted, that because of the interaction of developing creditor protection law and federal bankruptcy law, creditor protection may also be in some doubt for even residents of DAPT states for 10 years after a trust's creation. Generally, it does not matter to the IRS that such a creditor of the grantor exists. What matters to the IRS is that the grantor could create such a creditor who could attach the trust assets. *See* the discussion *supra* Section IX.A.3.e.

(2) Having the presence of an adverse party does not prevent the application of IRC Sec. 673 to make a trust a grantor trust.

IRC Sec. 673 provides for grantor trust treatment, if the settlor of a trust holds a reversionary interest in income or principal worth more than 5% of the trust's value at its inception. IRC Sec. 673(c) provides that discretionary powers should be assumed to be exercised to maximize the value in favor of the grantor "in determining whether a reversionary interest has a value in excess of 5%."

However, until recently, this statutory language has not been interpreted to suggest that a discretionary exercise in favor of the grantor can be assumed to determine whether a reversion actually exists. While the term reversion is not defined, it has traditionally been defined by the

IRS as the interest remaining with the owner of a vested estate upon transferring a lesser vested estate to another person. Under this definition, if a grantor has transferred his entire interest, and not a lesser interest, then IRC Sec. 673 should not apply. However, in PLR 201642019, the IRS revoked part of PLR 201426014 and held that under IRC Sec. 673(c), the subject trust was a grantor trust, because members could resign from a distribution committee, which under the terms of the trust would cause the trust to terminate and revert to the grantor. An IRC Sec. 673(c) "fix" for this IRS position might be to draft the trust to provide if such resignations occurred, the ING trust would continue without providing the trustee with any discretion to make distributions to the grantor.

b. The ING trust also needs to be designed in a manner where certain retained powers by the grantor exist which will make the trust incomplete for gift tax purposes, but those retained powers must not make the trusts grantor trusts.

For a gift in trust to be wholly incomplete for gift tax purposes, as to both its current and remainder interests, the grantor needs to retain controls over the current and remainder future disposition of the trust assets.

(1) The grantor needs to retain a testamentary power of appointment over the remainder beneficiary interests of the trust.

However, retaining a testamentary power of appointment arguably only makes the transfer to the trust an incomplete gift with respect to the remainder. That retained power does not make the trust a grantor trust. See IRC Sec. 674(b)(3).

(2) The grantor needs to also have powers that make the grantor's transfer to the trust incomplete for its current beneficiary interests.

(a) The grantor could have a retained power under which distributions could only be made from the trust with the consent of the grantor and the majority of a distribution committee.

The IRS position is that for gift tax purposes, the distribution committee does not have a substantive adverse interest to the grantor to the exercise of that power. See Treas. Reg. §25.2511-2(e) and PLR 201310002. Interestingly, as noted above, the same distribution committee may be adverse for income tax purposes, if they have potential current interests.

(b) The grantor could retain the sole power to make trust distributions from trust principal for the health, education, maintenance and support of his descendants.

Since such a power is a non-fiduciary power it makes the grantor's transfer incomplete for its current interests. See Treas. Reg. §25.2511-2(c) and PLR 201310002. However, that retained power does not make the ING trust a grantor trust for income tax purposes. See IRC Sec. 674(b)(5)(A).

(3) Distribution committee members of an ING trust should avoid having a general power of appointment with the distribution powers that they have.

Otherwise, gift tax consequences for a member could occur if there is a release of a general power of appointment to allow a trust distribution to a beneficiary other than that member.

(a) The statutory exception under IRC Sec. 2514(c)(3)(A) could apply to avoid gift tax consequences for distribution committee members when a distribution is made to a beneficiary other than that committee member.

A general power of appointment is not deemed to exist if the holder can only exercise the power in conjunction with the person who created the power.

(b) The statutory exception under IRC Sec. 2514(c)(3)(B) could apply to avoid gift tax consequences for a distribution committee member when a distribution is made to a beneficiary other than that committee member.

A general power of appointment is not deemed to exist if the holder can only exercise the power in conjunction with a person who is adverse to the exercise of the power. This exception applies in the context of a distribution power by unanimous consent of a distribution committee because if a co-holder of the power dies the remaining members of the committee will have a less diluted power. *See* Treas. Reg. §25.2514-3(b)(2).

(4) A state could interpret IRC Secs. 671-677 differently than the IRS does, or because of operation of state law, which is inconsistent with federal law, one or more of those sections apply to make the trust a grantor trust for state law purposes.

(a) For instance, a state may interpret IRC Sec. 673(c), or IRC Sec. 677, differently than the IRS does.

As noted above, creditors of a resident of a common law state may be able to attach the trust assets of a self-settled trust created in a DAPT state, which could make that trust a grantor trust under IRC Sec. 677. *See* the discussion *supra* Section IX.A.3.

(b) State grantor trust statutes could operate differently in that state than the Internal Revenue Code does.

For instance, in 2014 New York state passed legislation providing that a non-grantor trust created in another jurisdiction will be treated as a grantor trust for New York state income tax purposes, if the trust meets both the following requirements: (i) the trust qualifies as a grantor trust under IRC Sec. 671-679 and (ii) the grantor's transfer to the trust is treated as an incomplete gift.[126]

One solution for New Yorkers fearful of a future state capital gains tax event for one or more of their low basis assets is for them to consider contributing those assets to a trust located in a state that will not tax capital gains that qualifies as a QTIP trust. A QTIP trust is not subject to gift taxes because of operation of IRC Sec. 2523(f). That QTIP trust could be drafted to be taxed as a grantor trust for accounting income and a non-grantor trust for capital gains income. The QTIP should be designed to either prohibit a principal distribution (or at least a distribution of taxable gain) to a grantor's spouse, or require an adverse party's consent before a principal distribution could be made. In those states in which creditor protection is not affected, it would appear the spouse could be given a testamentary power of appointment, including a power to appoint back to a grantor. The fact that the trust is drafted to be a non-grantor trust for capital gains income will not make the trust a grantor trust for New York state income tax purposes, because the transfer of assets to the trust is a completed gift for gift tax purposes.

This technique may also be a solution for taxpayers who live in high state income tax states other than New York. It is easier to draft a trust, in which a grantor does not retain IRC Sec. 671-678 powers, if the grantor does not have to retain powers to make the trust an incomplete gift trust. It is true that the income of an inter vivos QTIP trust will be subject to the high state income tax state's income taxes, but that can be reasonably managed with the trust's asset class mix. For example, after the low basis assets are sold, the resulting sale proceeds could be invested in non-taxable bonds and/or low dividend paying stocks.

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[126] NY CLS Tax §612(b)(41).

3. The overall cumulative federal revenue considerations of the techniques described *supra* Sections X.A, B, C and D may lead Treasury to be more aggressive in protecting federal revenues.

To date, the IRS has been relatively benign in using the tools it has to prevent the creation of multiple non-grantor trusts, perhaps because that benign position generally did not affect federal revenues (in fact, in some cases those positions may have increased federal revenues). Because of the potential federal revenue loss identified above, the reader may conclude that benign IRS behavior may not continue. As noted, the IRS could use the tools of IRC Sec. 643(f) regulations (if they are issued), equitable tax doctrines (e.g., substance over form), developing creditor rights property law that grantors residing in common law states may have a disqualifying IRC Sec. 677 retained power to assign ING trust property to their creditors, and that all grantors residing in any state, because of developing creditor rights property law, may have a disqualifying IRC Sec. 677 retained power to assign ING trust property to their creditors for a 10 year period because of federal bankruptcy law.

However, the taxpayer, even if the IRS gets more aggressive in its enforcement, may still be able to create several non-grantor trusts that are not ING trusts, as long as the creator of those trusts complies with potential IRC Sec. 643(f) enforcement or equitable tax doctrine (e.g., "substance over form") enforcement.

XI. STRATEGIES THAT MAY LOWER THE INCOME AND HEALTH CARE TAXES OF TRUSTS WITHOUT MAKING CASH DISTRIBUTIONS TO THE BENEFICIARIES OF THE TRUSTS.

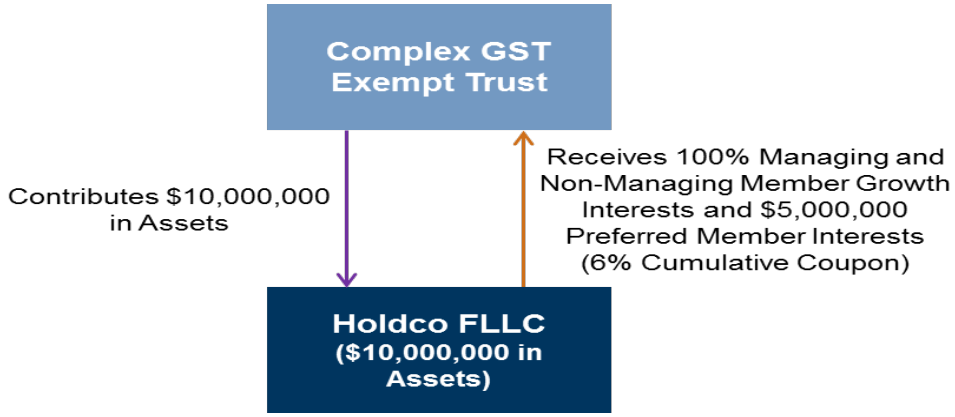
A. The Trustee of a Complex Trust Could Consider Creating a Two Class (One Class is a Preferred Interest and One Class is a Growth Interest) Single Member FLLC and the Trustee Could Distribute Part or All of the Preferred Class to the Current Beneficiary.

1. The technique.

The trustee of a trust could contribute part or all of its assets into a single member FLLC that has both preferred interests and growth interests. The owner of the preferred interest would be paid a fixed coupon and would also be entitled to a fixed liquidation value or "par" value on termination of the single member FLLC. The owner of the common interest would be entitled to the income and assets on liquidation that are not allocated to the preferred owner. The single member FLLC could have the right to call the preferred interest for cash equal to the par value of the preferred that is "called". The trust could also withhold part of the cash accruing from "called" preferred interests or the preferred coupon and pay that withheld amount to the IRS to satisfy the beneficiary's taxes associated with distributions and ownership of the preferred interest. Consider the following illustrated transactions.

Hypothetical Transaction 1:

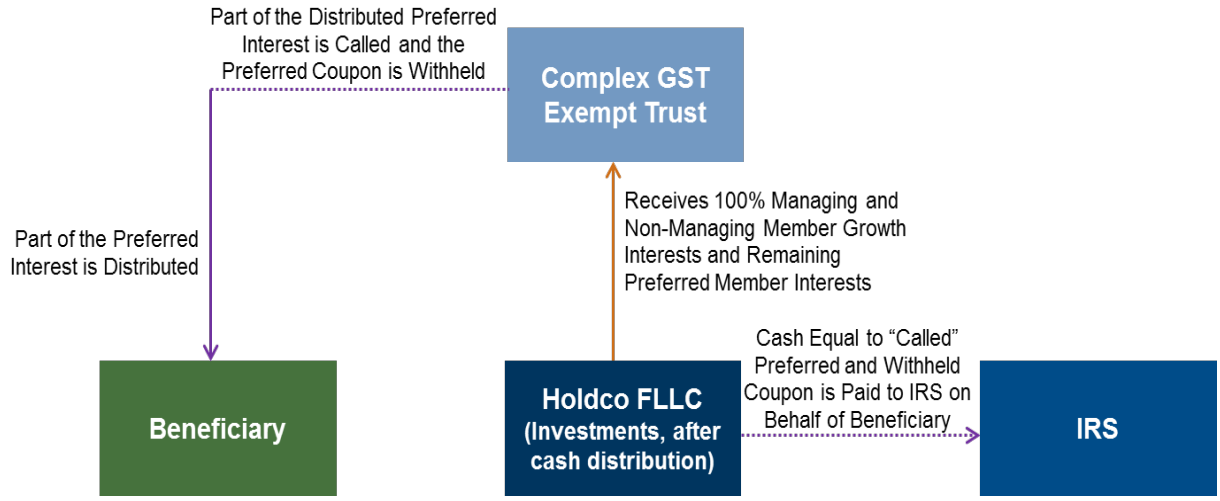
Trustee of Complex GST Exempt Trust, which has $10,000,000 in assets, forms a single member FLLC with preferred and growth member interests as illustrated below:



Holdco, FLLC has the right to "call" or "redeem" any portion of the preferred for cash and/or withhold any portion of a preferred coupon that is to be paid to its owner in order to make payments to the IRS on behalf of the owner of the preferred. The trustee of the Complex GST Exempt Trust could pay cash for that portion of "called" preferred that is owed and/or any portion of the coupon that is withheld, to the IRS for the benefit of the owner of the preferred.

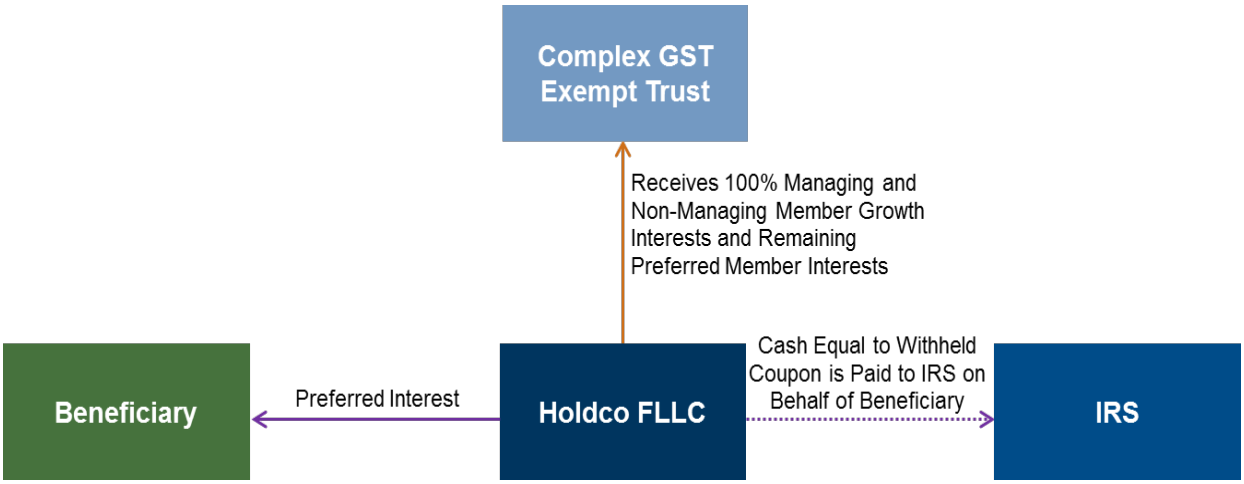
Hypothetical Transaction(s) 2:

Trustee of the Complex GST Exempt Trust could distribute part of its preferred interest to beneficiary. The par value of the distributed preferred is equal to the trust's adjusted gross income, as defined in IRC §67(e) over the dollar at which the highest bracket in IRC §1(e) begins for such taxable year. The trustee withholds the coupon payout that is due and "calls" or redeems part of the preferred. A cash amount equal to the "withheld" coupon and the "called" preferred interest is paid to the IRS on behalf of the beneficiary to be applied to the beneficiary's income taxes. This transaction can be shown as follows:



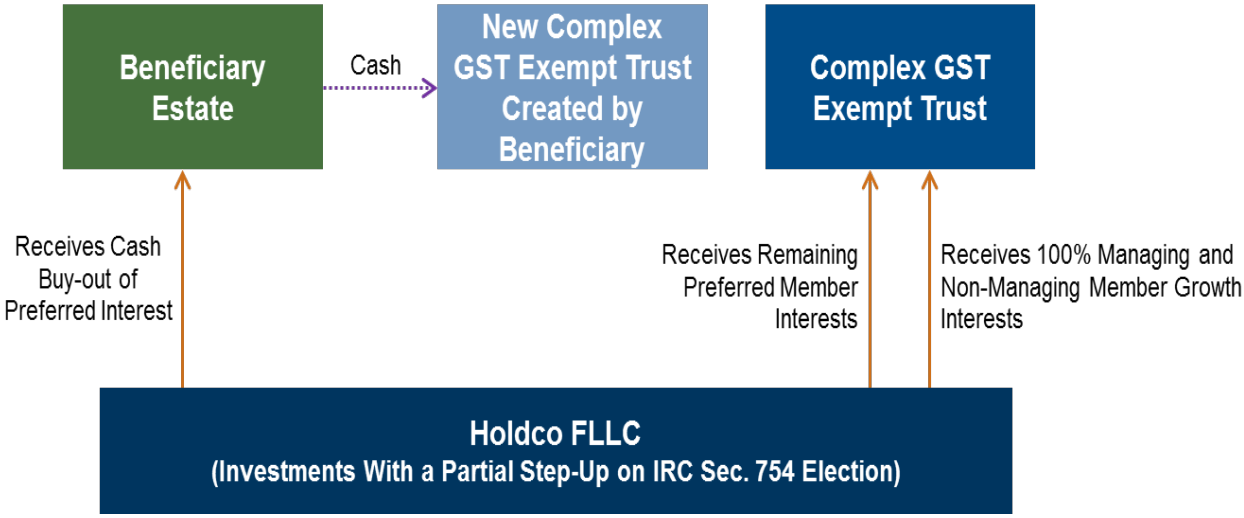
Hypothetical Transaction(s) 3:

In the later years, the trustee of the Complex GST Exempt Trust no longer distributes preferred partnership interests to the beneficiary. The trustee of the Complex GST Exempt Trust is not taxed on the net income allocated to the preferred interest owned by the beneficiary. Holdco, FLLC "calls" or withholds part of the cash coupon owed to the beneficiary and pays that cash to the IRS on behalf of the beneficiary:



Hypothetical Transaction 4:

Upon the beneficiary's death, the trustee may wish to redeem or "call" all of the preferred interest then held by the beneficiary's estate. If the beneficiary does not have a taxable estate and bequeaths the proceeds of the "called" preferred interest to a similar Complex GST Exempt Trust, that cash, upon redemption, will then pass according to the terms of the new trust. If an IRC §754 election is made, some of the low basis assets of Holdco, FLLC may receive a step-up in basis:



2. Income tax advantages of the technique.

a. Taxable income of the trust allocated to the beneficiary, either directly to the beneficiary because of the in-kind distributions of the preferred interest, or indirectly because of the payment of the preferred coupon, will not be taxable to the trust, which could save significant income taxes and health care taxes.

The fair market value of the preferred, when it is distributed to the beneficiary, will carry out distributable net income of the trust for that tax year. *See* IRC Secs. 661 and 662. The taxable income earned by Holdco that is allocated to the beneficiary as an owner, or part owner, of the preferred will not be taxed to the trust but will be allocated to the beneficiary. *See* IRC Sec. 704(b). If the beneficiary's income tax bracket is lower than the top bracket of the trust, then income taxes could be saved based on that difference.

b. If the trust contributes low basis assets to Holdco in exchange for the preferred, then distributes the preferred to the beneficiary, and if there is a later sale of those low basis assets by Holdco, significant future capital gains taxes could be saved.

If after distributing the preferred interest to the beneficiary, Holdco FLLC sells the highly appreciated securities that were exchanged for the preferred, the capital gains interest in the securities at the time of the exchange (the so-called "built-in gain") will be allocated to the beneficiary and will not be allocated to the other owners of Holdco (i.e., the trust). *See* IRC Sec. 704(c). Holdco could "call" part of the preferred, after the sale of securities, in order for the beneficiary to have sufficient cash to pay his taxes that are associated with the allocated gain. If the beneficiary is in a marginal bracket that is lower than the top marginal bracket of the trust, substantial capital gains taxes may be saved.

c. On the death of the beneficiary additional income tax and health care tax savings could accrue, if the stepped-up outside basis of the preferred interest owned by the beneficiary exceeds the proportionate inside basis of the FLLC Assets.

In this example, on the death of the beneficiary, Holdco could elect to have an adjustment of its inside basis on its assets under IRC Sec. 754 that are proportionately represented by the preferred interest. That election could save future capital gains and health care taxes when those assets are sold.

d. Unlike a trustee distribution of cash, a trustee distribution of a preferred interest in a closely held FLLC is not marketable, which could partially address spendthrift concerns.

The problem with a trustee distributing cash to a beneficiary in order to lessen the income tax and health care tax burdens is that cash can be spent by the beneficiary instead of being saved and bequeathed to future generations on the death of the beneficiary. A distribution of cash is

also readily available to creditors and spouses on divorce. It may be difficult for a beneficiary to find a buyer for the preferred interest. Secondly, the preferred interest could be subject to a buy-sell agreement. It is generally very likely the preferred interest will still be owned by the beneficiary on his or her death.

e. Unlike a distribution of cash, in which the trust loses its ability to return the earning potential of that cash for the benefit of future beneficiaries, the trust will indirectly retain the earning potential of the assets owned by the single member FLLC subject to the preferred coupon payment requirements.

If Holdco earns more than the coupon that is distributed to the beneficiary those excess earnings will accrue to the other beneficiaries of the trust.

f. The valuation rules of IRC Sec. 2701 probably do not apply to these illustrated transactions.

The valuation rules of IRC Sec. 2701, which apply for gift tax purposes in valuating gifts of common interests in a manner that overrides the hypothetical willing buyer, willing seller standard should not apply in this context. IRC Sec. 2701 does not apply for generation-skipping purposes. Secondly, IRC Sec. 2701 does not apply, if preferred interests are transferred instead of being retained. *See* discussion *infra* Section XII.B. Third, it is difficult to see how a distribution by a trustee to a beneficiary is a gift by any person as a donor, if the trustee is properly exercising fiduciary discretion. Since IRC Sec. 2701 does not apply, this may allow greater flexibility in designing the preferred to comply with the traditional willing buyer, willing seller standard.

3. Much greater inherent transfer tax advantages with this technique in comparison to transferring cash to a beneficiary in order to carry out DNI to a beneficiary who is in a lower tax bracket.

4. Considerations of the technique.

a. It adds a layer of complexity to the administration of the trust.

b. The beneficiary may bequeath the preferred interest in a manner that is inconsistent with the remainderman provisions of the complex trust.

These same considerations exist with a distribution of cash to the beneficiary.

c. Creditors of the beneficiary, including divorced spouses, may be able to attach the preferred interest.

These same considerations exist with a distribution of cash to the beneficiary.

B. Using Preferred Interests (Owned By a Trust in a High Tax State) and Growth Interests (Owned By a Trust in a Low Tax State) in a Partnership (or Vice Versa Depending Upon the Circumstances) to Shift Trust Income to a Low Tax State.

1. Scenario A.

Under certain facts, a complex trust may significantly reduce its income taxes and may increase its net worth, if it invests its assets in a partnership for a preferred interest and a grantor trust invests in the partnership for a growth interest. Consider the following example:

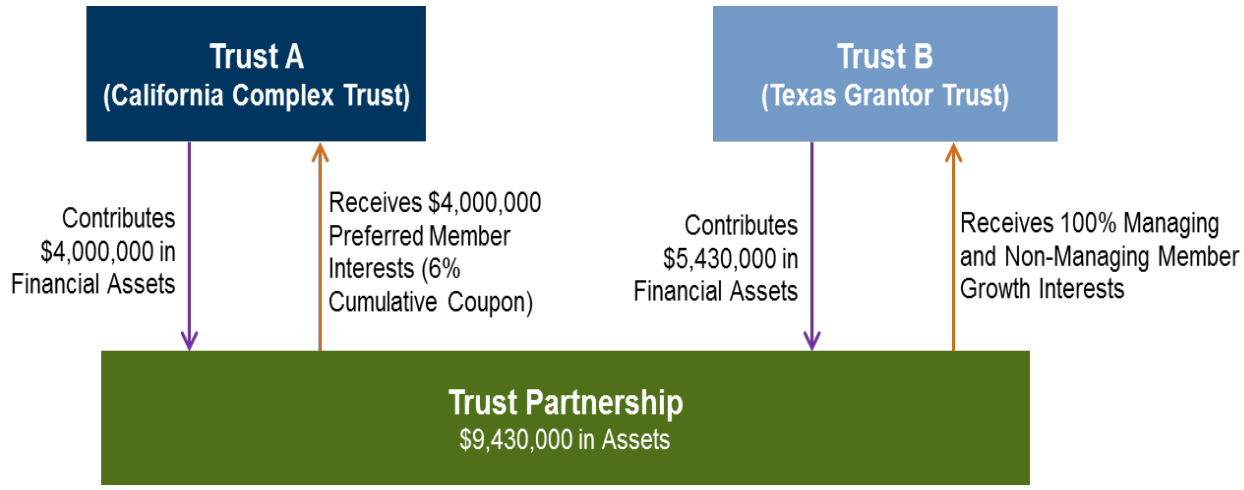
Example 13: Old Complex Trust Enters Into a
Two-Class Partnership With a New Grantor GST Trust

Gomer Gonetotexas is a discretionary beneficiary of a GST Complex trust that was created in California and is subject to California state income tax law ("Trust A"). Gomer now lives in Texas. Gomer has a $20,000,000 estate and does not need or want any distributions from Trust A. The beneficiaries of Gomer's estate are the same as the beneficiaries of the California complex trust. Gomer desires to lower the California state income taxes of Trust A and lower his estate taxes. Gomer does not want to pay any gift taxes. Gomer's living expenses are $500,000 a year. Gomer develops the following plan:

Trust A invests its $4,000,000 in financial assets for a $4,000,000 preferred interest in a FLP that pays a 6% cumulative return. Gomer creates Trust B with $5,430,000 in assets. Trust B is a grantor trust that is also a GST trust with similar beneficial interests to Trust A. Trust B contributes its assets for a growth interest in the FLP that is entitled to all of the income and growth of the partnership that is not allocated to the preferred interest. During the term of the partnership there are no distributions to the Trust A beneficiaries. Assume the partnership assets earn 7.4% before taxes a year with 3.4% of the return being taxed at ordinary rates and 4% of the return being taxed at long-term capital gains rates with a 30% turnover.

The proposed transaction is illustrated below:

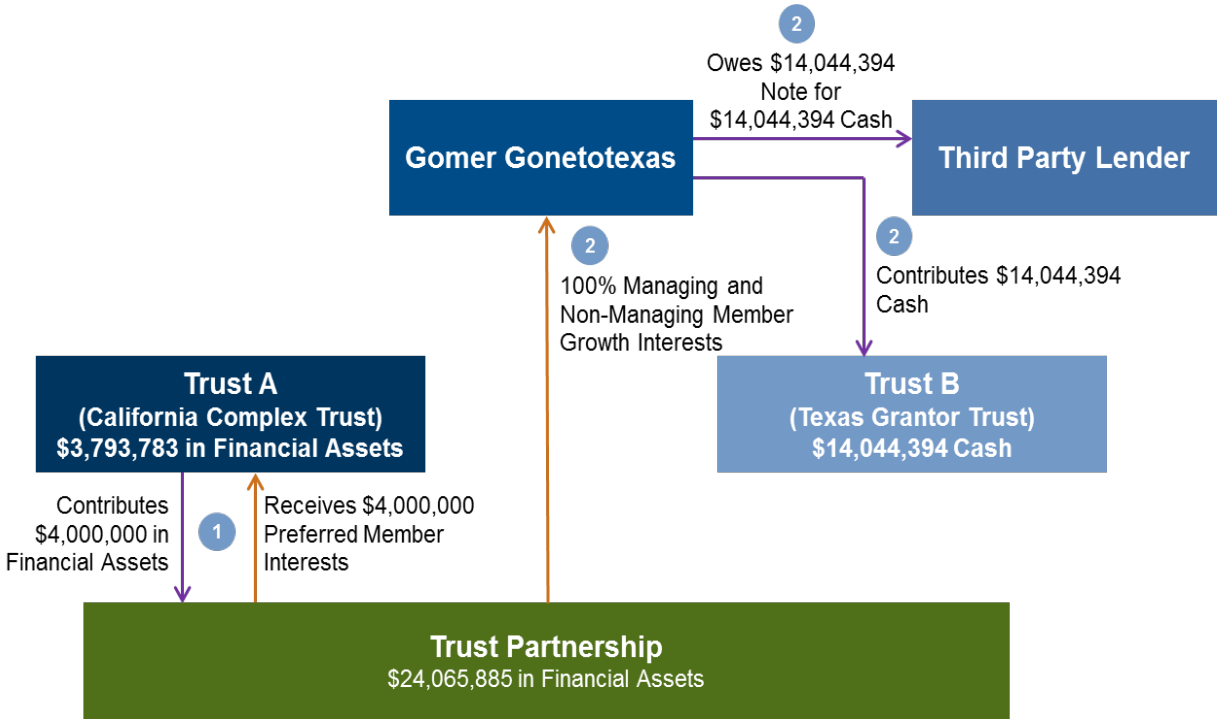
Transaction 1 (Scenario A):



Transaction 2 (Scenario A):

Assume Gomer, two years before he dies (and eighteen years after the original transaction), manages the contingent income capital gains taxes associated with Trust B's ownership of the growth interest by purchasing the growth interest with cash obtained by borrowing from a third party. *See* discussion *infra* Section VIII. That transaction is illustrated below:

Eighteen Years After Scenario A, Gomer Borrows Cash From Third Party
Lender and Buys Trust B's Growth Interest in the Trust Partnership For its Fair Market Value



It is assumed that the partnership is terminated shortly before Gomer's death and the third party lender is then paid.

2. Income tax advantages of Scenario A.

a. Under this arrangement and the assumed facts, the complex trust's income taxes will be significantly reduced and a significantly greater amount will pass to gomer's descendants.

The technique described is Scenario A in Table 7 below (*also see* attached Schedule 11). Over a 20-year period Trust A will pay 16.2% less in the total of state income taxes and associated investment opportunity costs by using this technique. If the beneficiaries of Trust A, Trust B and Gomer's estate are the same, Gomer's estate will save $3,380,750 in estate taxes and Gomer's descendants will receive $38,150,544 in assets in comparison to $33,727,835 in assets with no further planning.

Table 7

	Gonetotexas Beneficiaries			Consumption		IRS Income Taxes		CA Income Taxes		Opportunity Cost/ (Benefit) of 3rd Party Note	IRS Estate Tax (at 40.0%)	Total
	Children	Children & Grandchildren: California Complex Trust	Children & Grandchildren: Texas Grantor Trust	Direct Cost	Investment Opportunity Cost	Direct Cost	Investment Opportunity Cost	Direct Cost	Investment Opportunity Cost			
20-Year Future Values												
No Further Planning	$15,428,576	$9,609,259	$8,690,000	$12,772,329	$13,053,175	$14,277,270	$13,716,783	$1,257,693	$977,577	$0	$10,285,717	$100,068,380
Hypothetical Technique Scenario A	$10,357,451	$12,333,221	$15,459,872	$12,772,329	$13,053,175	$14,389,073	$13,719,802	$986,747	$887,382	($795,639)	$6,904,967	$100,068,380
Hypothetical Technique Scenario B	$10,165,130	$10,164,400	$18,638,941	$12,772,329	$13,053,175	$14,588,078	$13,924,521	$493,205	$443,626	($951,776)	$6,776,753	$100,068,380
Present Values (discounted at 2.5%)												
No Further Planning	$9,415,611	$5,864,252	$5,303,254	$7,794,581	$7,965,974	$8,713,003	$8,370,954	$767,534	$596,587	$0	$6,277,074	$61,068,825
Hypothetical Technique Scenario A	$6,320,851	$7,526,606	$9,434,710	$7,794,581	$7,965,974	$8,781,233	$8,372,797	$602,183	$541,543	($485,555)	$4,213,901	$61,068,825
Hypothetical Technique Scenario B	$6,203,483	$6,203,038	$11,374,804	$7,794,581	$7,965,974	$8,902,680	$8,497,730	$300,988	$270,732	($580,841)	$4,135,655	$61,068,825

b. This technique may be easier to manage than some of the other trust income tax savings techniques.

3. Transfer tax advantages of Scenario A.

a. The trustee of the complex trust does not have to distribute assets or cash to a beneficiary, or give a withdrawal right to a beneficiary, in order to save income taxes or health care taxes.

As noted above, there may be fiduciary concerns if distributions are made to a beneficiary solely to save income taxes. This technique eliminates that risk.

b. If the two trusts have identical provisions the valuation rules under IRC Sec. 2701 may not apply.

IRC Sec. 2701 valuation rules do not apply for generation skipping purposes. If the two trusts have identical provisions it is difficult to see a gift tax issue or fiduciary issues, if the creator of Trust B is not entitled to any distributions from Trust A because his standard of living

is met by other sources.[127] If there is no gift tax or GST tax issue, the trustee of Trust A, because Trust B has the same identical beneficiaries may believe it is in the Trust A beneficiaries' best interest to receive a 3% cumulative preferred interest instead of a 6% cumulative preferred interest in order to save state income taxes.

The technique described above is Scenario A in Table 7 above (*also see* attached Schedule 11). Over a 20-year period Trust A will pay 58.1% less in the total of state income taxes and associated investment opportunity costs by using this technique. If the beneficiaries of Trust A, Trust B and Gomer's estate are the same, Gomer's estate will save $3,508,964 in estate taxes and Gomer's descendants will receive $39,968,471 in assets in comparison to $33,727,835 in assets with no further planning.

4. Considerations of Scenario A.

   a. A party may not exist that could create a grantor trust that could invest and receive a preferred partnership interest.

   b. The technique is complex.

   c. In certain circumstances it may be better for the new grantor trust to own the preferred interest if a high coupon is warranted (e,g. 11% – 12%), because the new grantor trust is contributing 80% – 90% of the assets of the partnership. Under these circumstances, if the leveraged reverse freeze is used, the 80% – 90% preferred interest capitalization could be obtained with minimal gift tax consequences by using a contribution from the new grantor trust. Under those facts, consider scenario B described *infra* Section XI.B.5.

   d. In certain circumstances it may be more profitable for the old trust to sell the high basis assets to the new trust for a low interest (AFR Rate) note to the new trust.

   e. The IRS may argue that the valuation rules of IRC Sec. 2701 apply despite the identical provisions and beneficial interests of the two trusts.

   f. If there is not a buy-back of the growth interest by the grantor of the new grantor trust before the death of the grantor much of the income tax benefit will be lost because of the lack of step-up that accrues for the assets held in the new grantor trust.

[127] *See* Treas. Reg. §25.2511-1(g)(1) and *Saltzman v. Comm.*, 131 F.3d 87 (2nd Cir., 1997).

5. Scenario B.

Under certain assumptions, it may make sense to employ Scenario B: the preferred partnership interest is owned by a grantor trust in a low state income tax state and the growth interest is owned by a complex trust located in a high state income tax state.

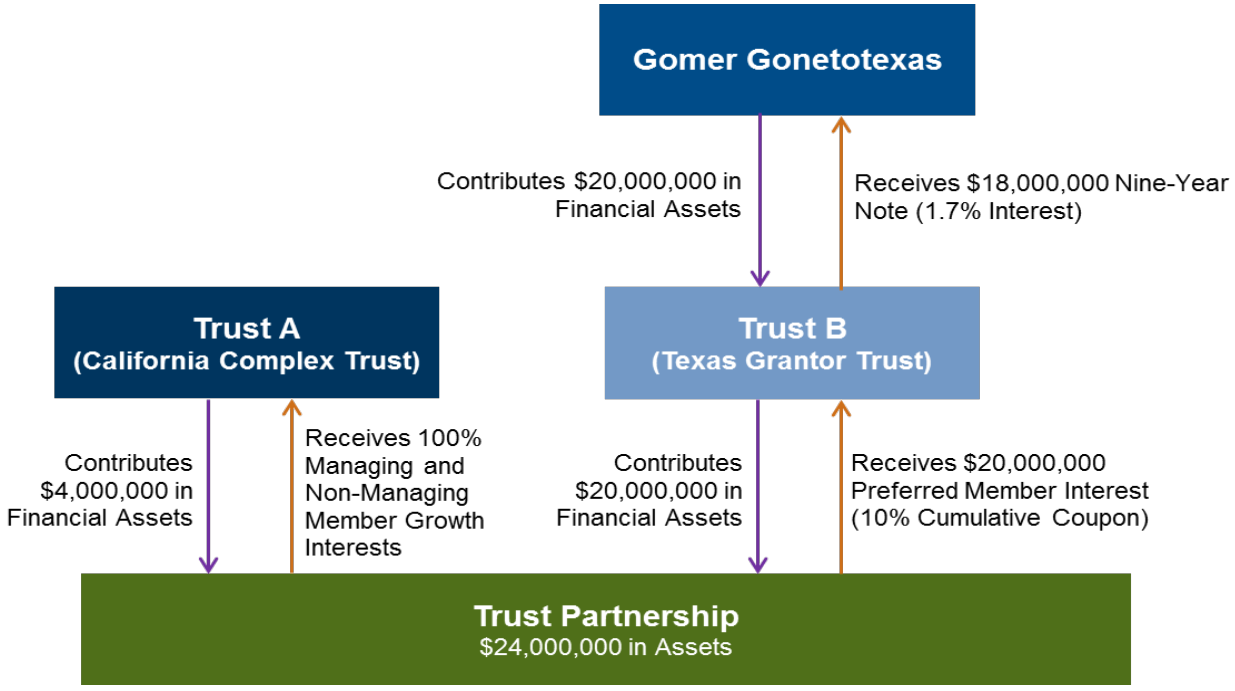
Consider the following example:

Example 14: A Leveraged Reverse Freeze is Used to Shift Trust Taxable Income From a High Income Tax State to a Low Income Tax State

The facts are similar to Example 13, except Gomer Gonetotexas contributes all of his net worth ($20,000,000) to a partnership with Trust A and receives a mezzanine preferred partnership interest that pays a cumulative coupon with a coupon rate that is consistent with Revenue Ruling 83-120 (that rate for purposes of this example is assumed to be 10%). Trust A will receive the growth interest. Gomer then contributes $2,000,000 of the preferred interest and sells $18,000,000 of his preferred interest to Trust B, which has the same provisions as Example 13, in exchange for a nine-year note that pays an AFR interest rate.

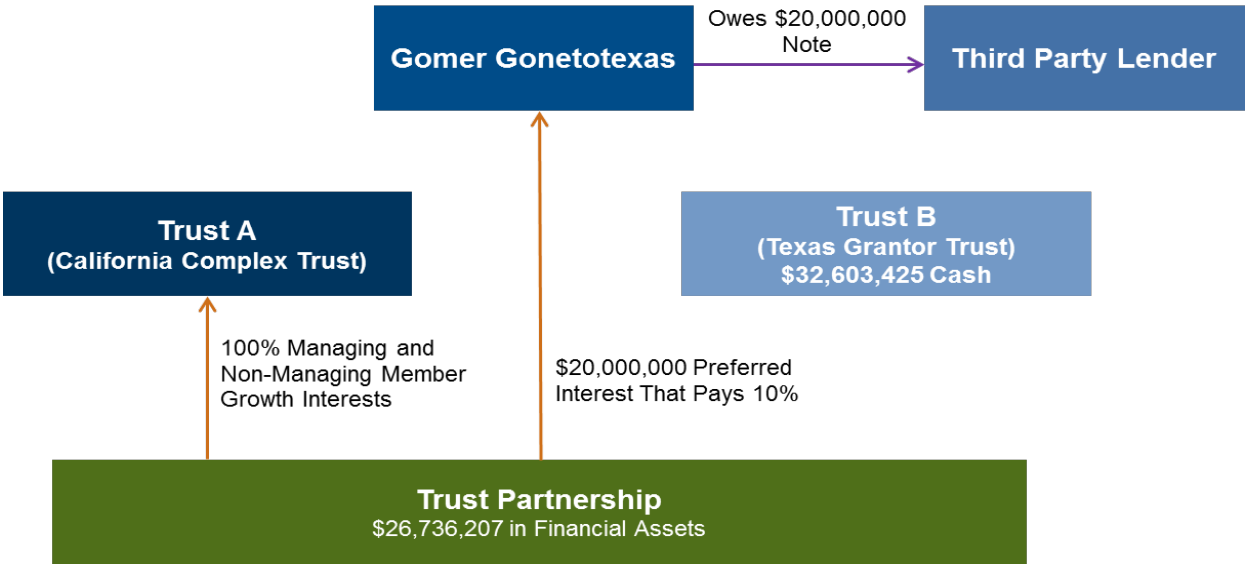
This example is illustrated below:

Transaction 1 (Scenario B):



Transaction 2 (Scenario B):

Seventeen Years After Scenario A, Gomer Borrows Cash From Third Party
Lender and Buys Trust B's Preferred Interest in the Trust Partnership For its Fair Market Value



For a full discussion of the reverse freeze technique *see infra* Section XII.B.

6. Income tax advantages of Scenario B.

   a. Significant state income taxes and the investment opportunity costs associated with those state income taxes can be saved with this technique.

See Table 8 below and attached Schedule 12. In this technique all of the potential state income taxes and the opportunity costs associated with those state income taxes are eliminated. Under the assumptions of this Example 14, $1,264,013 in state income taxes will be saved and $995,794 in investment opportunity costs on those state income taxes will be saved for a total savings of $2,259,807.

   b. Under the right facts, many of the state income tax advantages of this Scenario B will exist as they do for scenario A discussed *supra* Section XI.B.2.

7. Transfer tax advantages of Scenario B.

   a. Significant transfer taxes will be saved under this scenario.

See Table 8 below and attached Schedule 12. Under the assumed facts of this Example 14, all of the estate taxes are eliminated.

Table 8

	Gonetotexas Beneficiaries			Consumption		IRS Income Taxes		CA Income Taxes		Opportunity Cost/ (Benefit) of 3rd Party Note	IRS Estate Tax (at 40.0%)	Total
		Children & Grandchildren										
	Children	California Complex Trust	Texas Grantor Trust	Direct Cost	Investment Opportunity Cost	Direct Cost	Investment Opportunity Cost	Direct Cost	Investment Opportunity Cost			
20-Year Future Values												
No Further Planning	$15,428,576	$9,609,259	$8,690,000	$12,772,329	$13,053,175	$14,270,950	$13,698,567	$1,264,013	$995,794	$0	$10,285,717	$100,068,380
Hypothetical Technique	$0	$4,000,000	$43,359,947	$12,772,329	$13,053,175	$15,967,067	$14,173,982	$0	$0	($3,258,119)	$0	$100,068,380
Present Values (discounted at 2.5%)												
No Further Planning	$9,415,611	$5,864,252	$5,303,254	$7,794,581	$7,965,974	$8,709,146	$8,359,837	$771,391	$607,704	$0	$6,277,074	$61,068,825
Hypothetical Technique	$0	$2,441,084	$26,461,316	$7,794,581	$7,965,974	$9,744,237	$8,649,969	$0	$0	($1,988,336)	$0	$61,068,825

b. The trustee of Trust B may wish to use some of its positive cash flow from the transaction to purchase life insurance on the life of Gomer Gonetotexas, at least to the extent there may be estate taxes associated with Gomer's note.

The insurance could serve as a hedge to Gomer's early death. *See* discussion *supra* Section VII.C.1.

c. In general, this Scenario B has the same transfer tax advantages discussed in Scenario A, *see supra* Section XI.B.3.

8. Considerations of Scenario B.

Scenario B has many of the same considerations that are discussed *supra* Section XI.B.4.

C. The Complex Trust Could in Effect Convert Part of Its Assets Into an IRC Sec. 678 Grantor Trust in Which the Income is Taxed to the Beneficiary of the Trust By Having the Trust Invest in a Subchapter S Corporation and Converting that Part of the Trust Into a Qualified Subchapter S trust ("QSST").

1. The technique.

Many trust documents creating complex trusts provide that if any investment is made in a subchapter S corporation that part of the trust will convert into a QSST. Or, in appropriate

circumstances, a complex trust could be modified by court order to allow a Subchapter S investment by a QSST conversion for that investment. In order to ameliorate fiduciary concerns, assume the amount of distributions to the QSST beneficiary is taken into account by the trustee in determining the amount of the distributions, if any, to the beneficiary out of the assets of the complex trust that are not held in the QSST.

What is a QSST? A QSST is a trust that has only one income beneficiary and any corpus distributed during the life of the current beneficiary may only be distributed to that beneficiary. After an election is made by the beneficiary, the beneficiary is taxable on the taxable income of any Subchapter S stock that is owned by the trust as if the trust is a grantor trust to the beneficiary under IRC Sec. 678(a).

Under IRC Sec. 678(a) the trust is ignored for income tax purposes, at least with respect to any Subchapter S stock that is held in the trust. The IRS confirmed this grantor trust treatment of Subchapter S stock owned by a QSST as to the beneficiary of the QSST in Revenue Ruling 92-84.[128] The key holdings of that Revenue Ruling are as follows:

> Section 1361(d)(1)(B) of the Code provides that, for purposes of section 678(a), which sets forth the rules for when a person other than the grantor will be treated as a substantial owner, the beneficiary of a QSST shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under section 1361(d)(2) is made.
>
> …
>
> A has made the election under section 1361(d)(2) of the Code with respect to TR and M corporation. Therefore, under section 1361(d)(1)(B), A is treated as the owner of that portion of TR that consists of stock in corporation M for purposes of section 678(a).
>
> …
>
> Section 678(a) is within subpart E of subchapter J of the Code. Therefore, the provisions of section 671 are applicable to the stock of an S corporation with respect to which the beneficiary has made an election under section 1361(d)(2).
>
> Section 1.671-2(b) of the Income Tax Regulations provides that when it is stated in the regulations under subpart E that 'income' is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes.

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[128] *See* Rev. Rul. 92-84, 1992-2 C.B. 216.

Section 1.671-2(c) of the regulations provides that an item of income, deduction, or credit included in computing the taxable income and credits of a grantor or another person under section 671 is treated as if it had been received or paid directly by the grantor or other person (whether or not an individual).

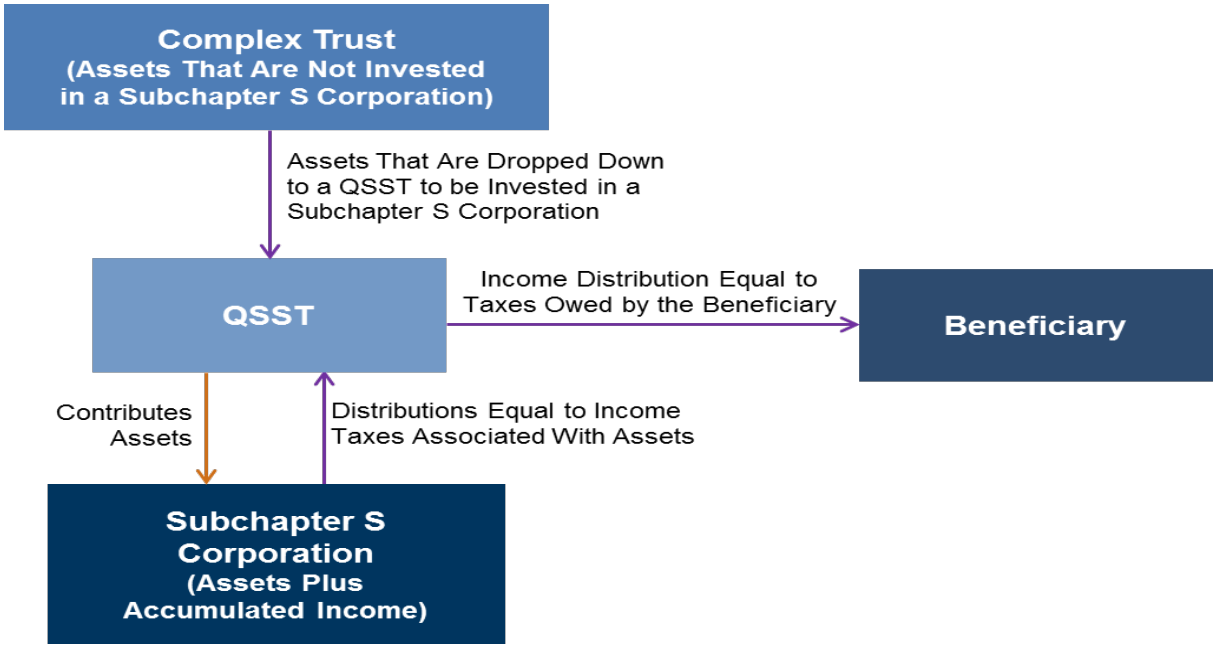
Section 1.671-3(a)(2) of the regulations provides that, if the portion treated as owned by a grantor trust or another person consists of specific trust property and its income, all items directly related to that property are attributable to that portion.

Accordingly, where a grantor or another person is treated as the owner of property constituting corpus under subpart E, the trust is disregarded as a separate entity and any gain or loss on the sale of such corpus is treated as gain or loss of such person.

It should be noted that the IRS revoked Revenue Ruling 92-84, because of cash problems caused by installment sales of Subchapter S stock by a QSST when it modified Treas. Reg. §1.1361-1(j)(8) in TD 8600 (7/20/1995). However, it would seem the other grantor trust aspects of the Revenue Ruling remain, which are consistent with IRC Sec. 1361 (i.e., for income tax purposes, the beneficiary of the QSST is treated as the income tax owner of any Subchapter S stock in the QSST and the beneficiary pays all of the income taxes on the Subchapter S income earned by the trust). It should also be noted that the trust assets other than the Subchapter S stock will be taxed under the normal Subchapter J rules.

After the trustee converts part of the trust assets to QSST, the trustee could manage the QSST in a manner which duplicates the result of a complex trust with lower income taxes. For instance, the trustee could only distribute that amount of cash from the trust owned Subchapter S stock that is necessary for the beneficiary to pay his income taxes.

The technique is illustrated as follows:



2. Income tax and basis enhancing advantages of the technique.

a. The beneficiary may be in a lower tax bracket than the trust.

The beneficiary may be in a lower tax bracket than the trust and is taxed on the taxable income allocated to the QSST. The taxes associated with the beneficiary being the deemed owner of the QSST may equal the cash distributed by the QSST to the beneficiary, which will limit any cash build up in the beneficiary's estate.

b. There is not any concern about the effect of any lapse of withdrawal rights.

Unlike the limited income withdrawal trust, or other IRC Sec. 678 beneficiary grantor trust techniques, there is no need for the beneficiary of the QSST to have withdrawal rights, because there is no attempt to make all of the assets taxed as a IRC Sec. 678 trust (only the Subchapter S stock owned by the trust). The transfer tax, income tax consequences and creditor protection consequences that may accrue from the existence of a withdrawal right, and from its lapse, are not present in this technique.

c. If the subchapter S corporation participates in a trade or business, and if the current beneficiary of the QSST materially participates in that trade or business, or is in a lower marginal bracket, significant health care taxes may be saved with the technique.

The net investment income, as noted above, is not allocated to the QSST, but is allocated to the beneficiary of the trust under IRC Sec. 678. Thus, if the beneficiary materially, or significantly, participates in the business of the subchapter S corporation there is not any tax. Secondly, even if the beneficiary does not participate, the beneficiary may be in a lower bracket than the trust.

d. The beneficiary of the QSST will have access to the accounting income distributed to the trust.

The beneficiary is the sole income beneficiary of the trust. The distributions could be adequate to pay the beneficiary's income taxes associated with the QSST.

e. The trust is much more flexible than a simple income only trust and may be administered to simulate a complex trust without the income tax and health care tax disadvantages of a complex trust.

The beneficiary is entitled to receive the distributions paid on the Subchapter S stock held in the trust, as an income beneficiary. However, the beneficiary pays income taxes (and health care taxes) on all of the income associated with the Subchapter S stock owed by the QSST. Much of the income earned by the subchapter S corporation could be retained by the corporation, and the trust and the subchapter S corporation could be managed to simulate a complex trust that does not pay income taxes, which only distributes that amount of cash necessary so that the beneficiary may pay his income taxes on the income earned by that trust.

3. The transfer tax advantage of this technique is that it preserves whatever inherent transfer tax advantage the trust has without distributing net cash assets from the trust to beneficiaries.

4. Considerations of the technique.

   a. The federal income tax considerations with utilizing a subchapter S corporation.

However as noted below, many of the income tax considerations may be either mitigated, eliminated, or do not really exist in comparison to certain of the techniques.

A subchapter S corporation is generally more advantageous from an income tax standpoint than a Subchapter C corporation, because there are not any corporate taxes to be paid for a corporation that qualifies. A subchapter S corporation can own passively managed assets, if the corporation has never been a C corporation.

One of the considerations of a subchapter S corporation is that only certain shareholders may qualify. Shareholders must be United States citizens. To the extent the Subchapter S stock is owned by a trust, the trust needs to be a grantor trust, a QSST or an electing small business trust (ESBT). Of these, the only trusts to which sales of Subchapter S stock may be made without realization of gain are grantor trusts (sale by the grantor) and QSST trusts (sale by the trust beneficiary).

Another consideration of a subchapter S corporation is that there is not a step-up on the underlying assets of the subchapter S corporation on the death of the shareholder who owns stock that is subject to estate taxes. FLPs and FLLCs, pursuant to certain elections that can be made under IRC Sec. 754, have the ability to have certain of the partnership assets receive an internal basis step-up on the death of a partner or member who owns the partnership interest or member interest (assuming the assets have appreciated). This may not be a significant consideration, if the planning goal is to have the stock out of the client's estate by the time of the client's death. Obviously, there would also not be a basis change under that goal and those facts, even if a partnership was used in the transfer planning – a taxpayer cannot receive a basis step-up on the underlying assets of the partnership assets, if the taxpayer does not own a partnership interest at the taxpayer's death.

Nevertheless, to the extent Subchapter S stock has not been transferred, and is included in a decedent's estate, the step-up in basis of a decedent's ownership of the Subchapter S stock will not be proportionately allocated to the subchapter S corporation's low basis assets as would be the case if the decedent owned a partnership interest and an IRC Sec. 754 election were made. However, in some cases, this disadvantage may only be one of timing. For instance, assume in the same year, after the death of the owner of the Subchapter S stock, the subchapter S corporation sells some of its low basis assets for cash in a transaction that generates capital gain. The corporation may use that cash to redeem the Subchapter S stock. The estate will be allocated its share of the gain on that subchapter S corporation sale, which will further increase the estate's basis in its Subchapter S shares. That redemption will generate a capital loss (since the estate's

basis is equal to its fair market value at death plus its share of the gain generated by subchapter S corporation sales of the low basis assets), which will be offset by the estate's share of Subchapter S gain on the sale of the low basis assets.

If future generations wish to terminate a subchapter S corporation, there may be immediate capital gains consequences in comparison to the assets being held in a partnership or FLLC. If the assets owned by the subchapter S corporation are sold immediately after, or before, the termination, that capital gains comparative disadvantage to a partnership organization may be mitigated. That inside basis disadvantage may also be mitigated by the use of drop down partnerships and leverage strategies, which are discussed *infra* Section XV.

b. Any income of the QSST that does not accrue from subchapter S stock earnings will be taxed under normal subchapter J rules.

As noted above, under Treas. Reg. §1.1361-1(j)(8), if there is a sale by the trustee of the QSST of any Subchapter S stock owned by the QSST, the QSST will be taxed on that sale under normal Subchapter J principles. The basis of the Subchapter S stock, that is to be sold, could be low because the only basis adjustment, after the sale of Subchapter S stock, will be the income of the corporation accumulated after the sale. It may be very important to eliminate any note outstanding to the Sec. 678 owner of the QSST, before the QSST sells its Subchapter S stock to a third party, in order to circumvent any income tax complications associated with the outstanding debt.

c. State income tax considerations.

Certain states may have different tax rules with respect to subchapter S corporations and the taxation of QSST trusts. Thus, the possibility exists that under many state laws, a sale to a QSST trust may be subject to state capital gains taxes and the beneficiary of the trust will not be taxed on the trust income. For example, a Missouri trust holds S corporation stock that owns Illinois real estate. When the real estate is sold, Illinois would tax the gain on the real estate, but the capital loss on liquidation of the stock would not be Illinois source loss, because the stock is not Illinois property.

D. A Trust That is Designed to Be a BDOT, or Reformed to Be a BDOT, Does Not Pay Any Trust Income Taxes and All of the Taxable Income is Allocated to the Beneficiary of the Trust.

1. The technique.

See the discussion *supra* Section IX.C.

2. Income tax advantages of the technique.

a. To the extent the beneficiary's effective rate is lower than what the trust's effective rate would be, income taxes are saved.

b. Since a BDOT is treated as a grantor trust to the beneficiary under IRC Sec. 678, the beneficiary can sell assets to the BDOT without any income tax consequences.

See the discussion *supra* Section IX.C.1, Example 9.

3. Transfer tax advantages of the technique.

See the discussion of the transfer tax advantages *supra* Section IX.C.

4. Considerations of the technique.

See the discussion of the consideration *supra* Section XI.C.4.

XII. LIFETIME CHARITABLE GIVING STRATEGIES THAT ALSO BENEFIT CLIENT'S DESCENDANTS.

A. Use of a LAGRAT When One of the Assets of the FLLC is a Non-charitable Interest in a Charitable Remainder Unitrust ("CRUT").

1. Introduction and the technique.

The "conventional wisdom" this author sometimes hears on this subject is as follows: "you can no longer use the CRUT technique and benefit your family;" or "the problem with charitable planning is that it will greatly decrease what a client's family will receive." This "conventional wisdom," under the circumstances discussed below, is incorrect.

Charitable remainder trusts, particularly charitable remainder unitrusts ("CRUTs") are a very popular planning technique for the charitably inclined client. While the technique has significant benefits to the client and his favorite charitable causes, one downside is the perception that it is difficult to benefit a client's family with the technique. Perhaps that is not true, if the technique is used synergistically with certain other estate planning techniques, that is, a LAGRAT. *That synergistic planning could simulate the following: a capital gains tax and estate tax holiday with the only "cost" (or additional benefit) being that the taxpayer's favorite charity receives a little over 20% of his remaining wealth on his death.*

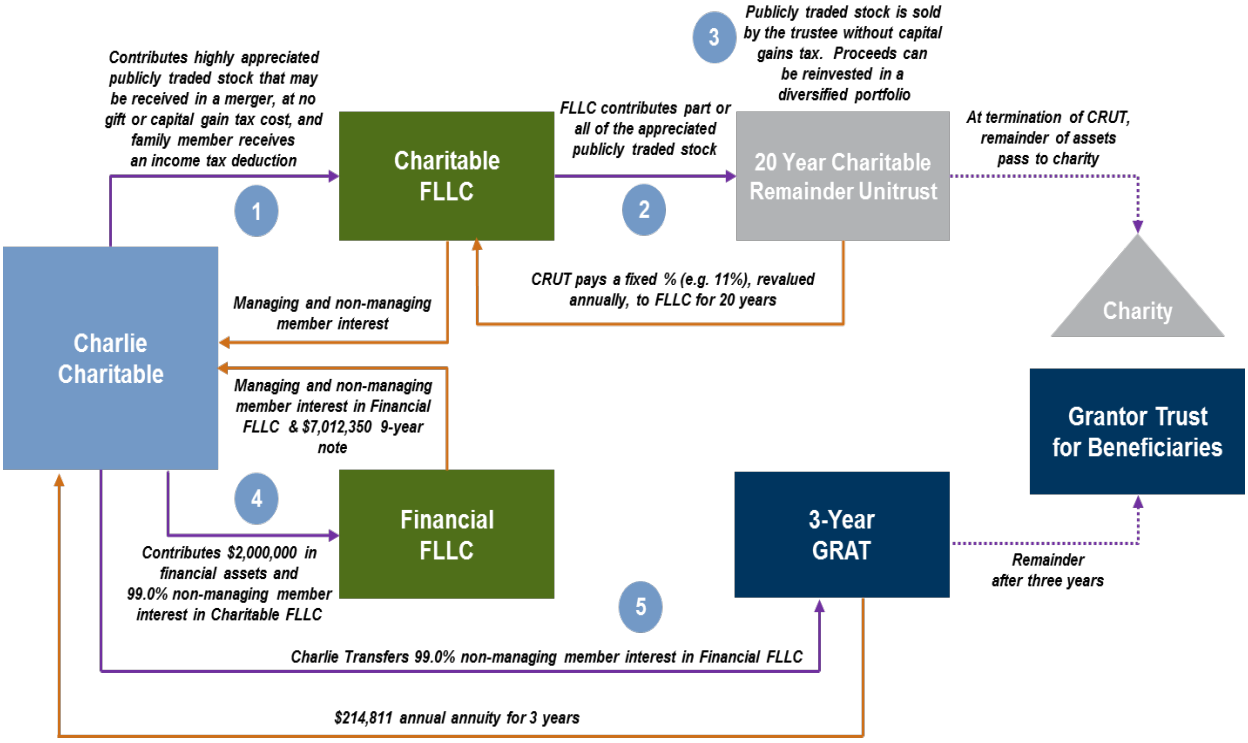
Consider the following example:

Example 15: Charlie Charitable Wishes to Benefit His Family, His Charitable Causes and Himself With a Monetization Strategy

Charlie Charitable, age 63, is widowed and has three adult children. Charlie owns $10 million of a publicly traded stock with a zero basis. Charlie also owns $2,500,000 in financial assets that have a 100% basis. He plans to spend $150,000 per year, indexed for inflation. If Charlie's spending needs are secure, he would like to give a large proportion of his after-tax wealth to his family, but he would still like to give between 20% and 25% of what he owns to his favorite charity. Charlie wants to diversify his stock position, but does not want to incur a big capital gains tax. Charlie has considered a CRUT, but he is concerned that charity could receive a windfall at the expense of his family if he dies prematurely. He is not certain he will qualify for favorable life insurance rates to insure against that risk and he generally dislikes insurance as a pure investment vehicle. Charlie would like his family to be eligible to receive some funds now, but he does not want to bear the gift tax consequences of naming family members as current CRUT beneficiaries. Charlie is also willing to take steps to reduce potential estate tax, and he needs help sorting through his options. He would like to involve his children in his estate planning discussions so they can learn about their obligations as fiduciaries and beneficiaries and can start to plan their own family and financial affairs.

Charlie's lawyer, Pam Planner, has a plan to help Charlie achieve his objectives, which significantly reduces the capital gains tax on the sale of his appreciated stock and minimizes the estate tax cost of transferring the stock proceeds to his family. Pam suggests that Charlie fund a Charitable FLLC with his stock, and that the FLLC creates a twenty-year term charitable remainder unitrust ("CRUT"). The FLLC will keep an up-front stream of payments for twenty years that represents a 90% actuarial interest in the CRUT. Charlie's favorite charity will receive the remaining CRUT assets at the end of the twenty-year term. The trustee of the CRUT could sell the stock and construct a diversified investment portfolio without triggering immediate capital gains tax consequences. If Charlie owns most of the Charitable FLLC when the CRUT is created, most of the income tax charitable deduction for charity's 10% actuarial interest will flow through to him. Charlie could then contribute his non-managing member interest in the Charitable FLLC along with most of his other financial assets to a leveraged FLLC (Financial FLLC) getting a note back for 90% of the value of the assets. Charlie can allocate GST exemption to the grantor trust so his family's wealth is potentially protected from gift, estate and GST taxes forever.

This technique is illustrated below:



A CRUT is an irrevocable trust, often called a "split interest" trust. When a donor creates a CRUT, he can keep or give away a continuing payment stream from the CRUT for a period of time. This payment stream is made to the "noncharitable" beneficiaries.[129] The time period can last for up to twenty years or for the lifetimes of one or more currently living noncharitable beneficiaries.[130] In private letter rulings, the IRS has permitted partnerships and corporations to create CRUTs where the unitrust term is measured in years instead of the lives of individuals.[131] In Charlie's case, the FLLC will be both the donor and the noncharitable beneficiary. The CRUT

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[129] IRC Sec. 644(d)(2)(A); Treas. Reg. § 1.664-3(a)(1).

[130] Treas. Reg. § 1.664-2(a)(1).

[131] *See* PLR 9205031 (Jan. 31, 1992) (C corporation); PLR 9340043 (S corporation); PLR 9419021 (Feb. 10, 1994) (partnership). Under Treas. Reg. § 1.671-2(e)(4), if a partnership or corporation (an "entity") makes a gratuitous transfer to a trust for a business purpose, the entity is generally treated as the grantor of the trust. However, if an entity makes a gratuitous transfer to a trust for the personal purposes of one or more partners or shareholders, the gratuitous transfer is treated as a constructive distribution to the partners or shareholders and they in turn are treated as the grantors of the trust. The IRS has taken the position that a CRT with multiple grantors is an association taxable as a corporation. *See* PLR 9547004 (Nov. 24, 1995); PLR 200203034 (Jan. 18, 2002). If the IRS takes the position that Charlie's partnership created the CRUT all or in part for the personal purposes of its partners, then the CRUT may not be valid. If a practitioner is concerned about this result, Charlie could accomplish the transaction by funding a single member FLLC, having the FLLC create the CRUT, and then selling a portion of the FLLC to a grantor trust so that there is only one grantor and income tax owner for the entire series of transactions.

must pay a fixed percentage of the annual value of its assets to the FLLC each year, so the unitrust payments will fluctuate along with the value of the CRUT's investments.

At the end of the unitrust period, the trustees of the CRUT will distribute the remaining assets to one or more qualified charitable beneficiaries or will hold the assets solely for charitable purposes.[132] These charitable beneficiaries can include private foundations and donor advised funds.[133]

The FLLC, as the donor, will pass through a current income tax deduction for the value of charity's interest to the members in the year it funds the CRUT. The value of the deduction depends on the value of the assets contributed to the CRUT, how long charity must wait to receive its interest, the size and timing of the partnership's reserved unitrust payment, and an assumed investment rate of return (called the IRC Sec. 7520 rate) that the IRS publishes monthly.[134] Because Charlie will own almost all of the FLLC when the CRUT is created, he will receive most of the deduction. Generally, Charlie can deduct up to 30% of his adjusted gross income for the transfer of appreciated marketable securities to the CRUT (20% if the remainderman is a private foundation), and he can carry forward any excess deduction for five years.[135]

Pam lists some of the key CRUT rules for Charlie:

a. The FLLC, as the noncharitable beneficiary, must receive an annual unitrust payment.[136] This unitrust payment is a fixed percentage of the fair market value of the trust's assets, revalued annually. There are exceptions to this rule that allow some CRUTs to distribute net income instead, but these extra rules are not relevant for Charlie.

b. The unitrust payment must be at least 5%,[137] but not more than 50%,[138] of the fair market value of the trust's assets, determined annually.

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[132] IRC Sec. 664(d)(2)(C).

[133] Qualified organizations are described in IRC Secs. 170(c), 2055(a), and 2522(a).

[134] The IRC Sec. 7520 rate is 120% of the federal midterm rate. The partnership can choose the rate in effect for the month of the gift or for either of the two immediately preceding months.

[135] IRC Sec. 170(b)(1)(B), (b)(1)(D). If a private foundation were the named remainderman and the stock of XYZ Company were not publicly traded, the deduction would be limited to basis (here, zero), and could not exceed 10% of XYZ Company's stock. IRC Sec. 170(e)(1)(b)(ii), (e)(5)(C).

[136] IRC Secs. 664(d)(1)(B), (2)(B); Treas. Reg. § 1.664-3(a)(1)(i).

[137] Treas. Reg. § 1.644-2(a).

[138] IRC Sec. 664(d)(1)(A), as amended by The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 787 (1997).

c. At the CRUT's inception, the actuarial value of charity's interest in the CRUT must be worth at least 10%.[139] The CRUT can receive additional contributions as long as each additional contribution satisfies the 10% rule.[140]

d. The CRUT does not pay income taxes.[141] The CRUT distributions carry out income tax consequences to the noncharitable beneficiary in a specific order: First, as ordinary income to the extent of the trust's current and past undistributed ordinary income (dividends that are taxed at 15% are included in this tier); second, as capital gains to the extent of the trust's current and past capital gains; third, as tax-exempt income to the extent of the trust's current and past tax exempt income; and finally, as a nontaxable return of capital.[142]

e. Charlie must factor in additional legal, accounting and administrative costs. Since every unitrust payment depends on an annual valuation of the CRUT's assets, hard to value assets might generate appraisal costs, too.[143]

f. The trustees of the CRUT do not have unlimited investment flexibility. There is a 100% excise tax on unrelated business taxable income (UBTI) generated in a CRUT. Broadly defined, UBTI is income derived from any trade or business. UBTI includes debt-financed income, so certain investment strategies that use borrowing might be off limits. Also, the self-dealing rules that apply to charitable trusts prohibit Charlie from transacting with the CRUT, even if the transaction is completely fair.[144]

Charlie is interested in Pam's idea but it seems complicated, so he wonders if the plan is really that much better than just selling his stock. He also wonders how much taxation truly affects the real wealth he can transfer to his family over time. Charlie has already created a successful intentionally defective GST exempt trust so he has been through the planning process before. Still, he is eager to get a lucid explanation of some planning techniques to start educating his children and he wants to understand how the techniques can be combined to achieve his objectives.

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[139] IRC Sec. 664(d)(1)(D).

[140] Treas. Reg. § 1.664-3(b).

[141] IRC Sec. 664(c)(1). Charlie's advisors will also want to ascertain the tax treatment of the CRUT under applicable state law. Most states recognize CRUTs as tax exempt, but some, *e.g.*, New Jersey, do not. It will usually be possible to establish the partnership and CRUT in a state recognizing the exemption regardless of where Charlie lives.

[142] IRC Sec. 664(b); Treas. Reg. § 1.664-1(d)(1).

[143] Treas. Reg. § 1.664-1(a)(7).

[144] IRC Sec. 4941.

2. Income tax and basis enhancing advantages of the technique.

a. The income tax advantages of creating a LAGRAT.

See discussion *supra* Section VII.B.

b. The income tax advantage of eliminating the capital gains tax on that part of the gains that will be allocated to the charity under the tiered income tax rules.

Depending upon the investment performance of the assets held in the CRUT a portion of the built-in capital gains will be allocated to the charity under the tiered income allocation rules. Treas. Reg. § 1.664-1(d)(1). Assuming a 6% to 8% annual return of the CRUT assets during the 20 year term of the CRUT 40% to 60% of the original built-in gain will be allocated to the charity on termination of the CRUT and that portion of the gain will not be taxed when the asset is sold in year one.

c. The income tax advantage of lowering opportunity costs by delaying taxes on the portion of the original gain that is not allocated to charity.

If tax rates stay the same, it is better for Charlie to defer paying taxes so he can use those tax dollars to generate investment returns. Paying taxes earlier than necessary is an opportunity cost.

d. The income tax advantage of a charitable deduction in year one for the actuarial value of the remainder interest of the CRUT passing to charity.

Under the facts of this example, Charlie will receive an income tax deduction equal to 10% of the value of the CRUT assets. The benefits of that tax deduction occur in year one.

e. The tax advantage of integration, which produces advantageous comparative results.

Charlie can use a combination of gift and estate planning techniques to achieve his objectives. But the plan also requires investment strategies that support the income tax, cash flow and appreciation targets necessary to promote its success.

Charlie, his children and the trustees then show the plan to their investment advisor. The advisor constructs a sample diversified portfolio inside the CRUT that targets an annual 7.4% pre-tax return, with 3% of the return being taxed at ordinary income or short term gains and the balance 4.4% of the return being taxed at long term capital gains rates. Generally, the advisor projects an annual 30% turnover – that is, on average the trust will need to sell and reinvest 30% of the portfolio every year. It is assumed that the total taxes on realized long-term capital gains (including income taxes, surtax on investment income and the so-called “stealth” tax), will be

25%. It is also assumed that total taxes on ordinary income will be 44.6% (including income taxes, surtax on investment income and the so-called "stealth" tax).

Charlie, the children, the trustees and their investment advisor consider how to produce the annual CRUT payments; how much could be in cash and in kind; what happens when the CRUT distributes its unitrust payments to the Charitable FLLC and the Charitable FLLC distributes some or all of the unitrust payments to Financial FLLC; Financial FLLC's repayments of Charlie's note; and how to reinvest those distributions to meet the differing objectives for Charlie, the charity, Financial FLLC and the grantor trust that is the remaindermen of the GRAT. They think through contingency plans to cope with inevitable investment volatility, or the ups and downs that happen in every diversified investment plan. They analyze the different types of note: a "slow" note that preserves leverage for a longer time, and a "fast" note that eliminates the uncertain tax issues at Charlie's death. Charlie decides he would like the trust to repay his note as soon as possible, so the repayment is built into the plan.

To show Charlie the difference that taxes play in accumulating family wealth over time, Pam projects what would happen if there were no initial capital gains taxes when Charlie sells his stock and no estate taxes. She also projects what would happen if Charlie contributed non-managing member interests in Charitable FLLC to Financial FLLC without including the CRUT component. If the investment plan produced smooth returns until Charlie's death (which the group agrees to project twenty-five into the future), the results would look like this (*see* Schedule 13):

Table 9

Hypothetical Technique (Assumes $9.83mm Estate Tax Exemption Available)	Charlie's Descendants	Charity	Charlie's Consumption Direct Costs	Consumption Investment Opportunity Costs	IRS Taxes on Investment Income	IRS Investment Opportunity Costs	IRS Estate Taxes (@40.0%)	Total
Future Values at the end of 25 Years Assuming an Annual Compounded Rate of Return at 7.4%								
Stock Sale, No Planning	$19,745,860	$0	$5,123,665	$7,440,046	$11,792,247	$23,763,728	$6,610,574	$74,476,121
Simulated Tax Holiday (No Initial Capital Gains Tax and No Estate Tax) 78% - 22% Split Between Family and Charity	$27,251,647	$7,539,379	$5,123,665	$7,440,046	$11,817,313	$15,304,071	$0	$74,476,121
LLC/CRUT/Holdco/LevGRAT, Charlie gives remaining estate to charity	$24,972,689	$7,539,379	$5,123,665	$7,440,046	$12,581,416	$16,818,926	$0	$74,476,121
LLC/Holdco/LevGRAT (no CRUT), Charlie gives remaining estate to family	$25,552,526	$0	$5,123,665	$7,440,046	$12,596,156	$23,763,728	$0	$74,476,121

Using the above assumptions, Charlie will not pay tax on approximately half of the capital gains generated when the CRUT sells the stock. Under the CRUT tiered income distribution rules, approximately half the gain will still be inside the CRUT at the end of twenty years when charity receives the remainder. Although Charlie does pay some capital gains tax on the other half of the gain, he still takes advantage of two of Pam's key concepts: He defers the capital gains tax payment until the CRUT makes distributions, and his estate does not pay estate tax on those capital gains tax payments. In effect, the grantor trust repays Charlie's installment note using pre-tax dollars.

Charlie is currently subject to a combined federal and state transfer tax rate of 44.6%. On the one-half of the capital gains taxed to Charlie (because the rest of the capital gain is still embedded in the CRUT when it passes to charity), Charlie avoids transfer tax on the dollars he spends to pay capital gains tax. Charlie has already paid those dollars to the IRS and so they have been eliminated from his transfer tax base. That means Charlie's total effective capital gains rate on his $10,000,000 stock sale turns out to be less than 7.5% instead of 25% (prior to considering the 4.46% charitable income tax subsidy and the "time" described below). In other words, it costs Charlie a net of 3% of the proceeds in taxes to sell the stock using the proposed technique instead of 25%, even before the time advantage of delaying the payment of the capital gains tax is considered.

Although the simple stock sale generates the lowest amount of income tax – $11,792,247 – the combined total income tax cost of combining income tax with the lost opportunity cost of paying the capital gains tax in year one is $35,555,975, which is dramatically more than in the next two sets of projections (the simulated tax holiday and Pam's CRUT plan) because the early stock sale tax payment contributes to $23,763,728 in investment opportunity costs. Since Charlie pays capital gains tax immediately on the stock sale, his family loses the benefit of reinvesting those tax dollars. On top of that, the simple stock sale without estate planning piles on another $6,610,574 of estate tax. In contrast, there is no estate tax liability at all in the next three projections.

Because Charlie will own more than 99% of the FLLC when the FLLC funds the CRUT, the FLLC will pass through more than 99% of the charitable income tax deduction to Charlie. The deduction equals 10% of the fair market value of the assets contributed to the CRUT, or $1,000,000. In Charlie's case, it is assumed the deduction offsets $1,000,000 of his ordinary income, so it yields a $446,000 income tax benefit. In effect, the income tax deduction pays Charlie a 4.46% subsidy for his $10,000,000 transaction.

The two middle rows of numbers compare Pam's plan to a simulated tax holiday. Both sets of projections shows a total tax burden (which includes the investment opportunity costs of paying the tax) that is less than 65% of the aggregate tax bill generated by the simple stock sale with no planning. Charlie detects only one difference between Pam's plan and the simulated tax holiday. In Pam's plan, the total projected tax cost is an additional $2,278,958 (or 8.4% of the roughly $27,121,384 tax burden in the simulated tax holiday). That $2,278,958 reduces what Charlie's family would keep in a world with no initial capital gains tax on big stock sales and no estate taxes.

Pam asks Charlie to consider the projected outcome if he contributes non-managing member interests in Charitable FLLC to a LAGRAT, but the FLLC does *not* transfer its appreciated securities to a CRUT first. Those projections are in the final row. Charlie sees that his descendants would end up with $25,552,526, if Charitable FLLC did not create the CRUT, or $579,837 more than they would have received, if the FLLC did create the CRUT. Pam explains that when the FLLC creates the CRUT, the trustees do not pay immediate capital gains tax when they sell the stock, and Charlie receives a charitable income tax deduction up front. Without the CRUT, the larger note from the contribution to the LAGRAT, the early payment of taxes and lack of income tax subsidy compounds over time, so that at the end of the day, Charlie's family pays additional taxes and opportunity costs that cost almost as much as the future $7,539,379 gift to charity. Thus, there is comparatively little net cost to Charlie's family to transfer around $7,539,379 to charity. In fact, in states where a state capital gains tax exists, the net worth of Charlie's family generally *increases* with the use of the CRUT technique.

Although Charlie clearly sees that the two middle rows of numbers – Pam's plan against a simulated tax holiday – produce a nearly identical result, Pam presses the benefits of understanding leverage and opportunity costs even further. If Charlie allocates $617,087 in GST exemption to the GRAT on its creation (assume Charlie is 60 years old), he will protect more from further transfer taxes by the time of his death. This benefit compounds as the property moves down the generations. By using his GST exemption wisely, Charlie not only solves some of his tax problems, but he also solves some of his descendants' tax problems as well.

3. Considerations of the technique.

a. Generally, Investments that are made inside the CRUT should be marketable stocks and bonds. a trustee of a CRUT should avoid any investments that may have unrelated business taxable income.

b. The technique will have the same considerations as the creation of a LAGRAT.

See discussion *supra* Section VII.C.

B. Creating a FLP or FLLC with Preferred and Growth Interests, Transferring the Preferred Interest to a Public Charity, and Transferring the Growth Interests to a LAGRAT.

1. The technique.

There could be significant after-tax cash flow advantages for giving preferred interests in a FLLC that is designed to last for several years to a public charity, or a donor advised fund, and transferring the growth interests to a taxpayer's family.

Consider the following example.

Example 16: Gift of a Preferred FLLC Interest to a Public Charity and the Gift or Sale of a Growth FLLC Interest to a Taxpayer's Family

George Generous is unhappy about some of tax limitations associated with traditional charitable giving. Not only do tax limitations exist with respect to the amount of a deduction available for income tax purposes, there also is not any deduction in determining the new healthcare tax. George's stewardship goals are to give around $420,000 a year to his favorite public charities and to give a $6,000,000 bequest to his favorite public charities in his will

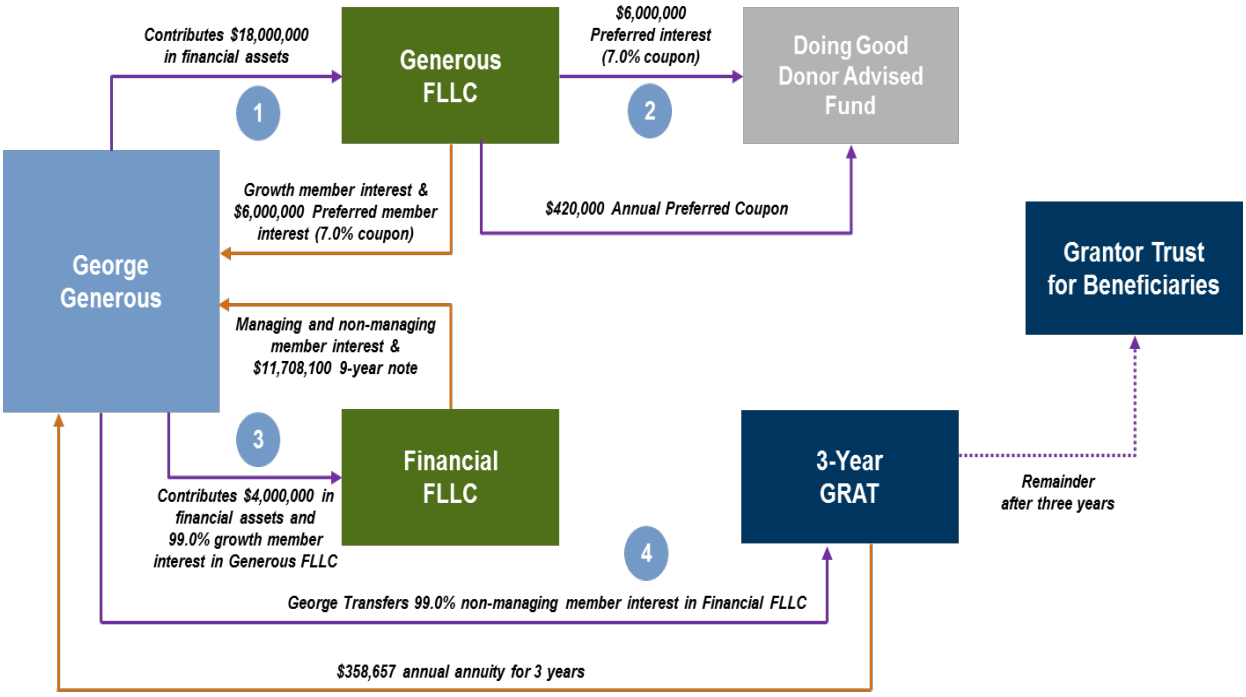
George tells Pam that he has a $6,000,000 zero basis security in his $22,000,000 portfolio. George asks Pam to assume his assets will annually earn 7.4%, with 3% of that return being taxed as ordinary rates and 4.4% of the return being taxed at long-term capital gains rates with a 30% turnover. George believes he has a 20-year life expectancy. George has a significant pension plan that pays for his consumption needs.

George asks his lawyer, Pam Planner, if she has any ideas that are consistent with his charitable intent where he can get a tax deduction for his projected annual giving without any limitations, both for determining his income tax and the new healthcare tax. He also asks Pam if she has any ideas of how he can get an income tax deduction this year for the actuarial value of the planned testamentary gifts he wishes to make to his favorite charitable causes. George also would like to hear Pam's best ideas on how to avoid the capital gains tax and healthcare tax on the projected $6,000,000 sale of some his highly appreciated securities.

Pam Planner suggests that George consider forming a FLLC that will last until the earlier of his death, or 50 years. The FLLC is structured to have both preferred and growth interests. George could contribute $22,000,000 of his assets to the FLLC. George could contribute his low basis securities to the FLLC and receive a $6,000,000 preferred interest that pays a coupon of 7% (or $420,000 a year). The rest of his member interests, the so-called "growth" interests, would receive any income or gains above what is necessary to fund the preferred coupon.

After the FLLC is formed, Pam suggests that George make a gift of the preferred FLLC member interest to his favorite charity, the Doing Good Donor Advised Fund (which is a donor advised fund at a local community foundation and is a qualified public charity). The Doing Good Donor Advised Fund is entitled to a 7% preferred coupon each year. George could gift and sell the growth interests to a trust for his family.

This technique is illustrated below:



2. Income tax advantages of the technique.

   a. The donor may receive an income tax deduction for the discounted present value of the charity's right to receive the par value of the preferred on termination of the FLLC, even though that might occur after the donor's death.

George may receive a full deduction for the present value of the right to receive the par value of the preferred interest when the FLLC terminates, even though no cash has passed from his hands to the donor advised fund and the payment of the preferred par value will probably occur after George's death. Contrast that treatment with a bequest of a dollar amount under George's will. Obviously, George will not receive a lifetime income tax deduction for that bequest.

   b. The donor should receive an income tax charitable deduction, in the year of the gift, for the discounted present value of the 7% coupon that is to be paid to charity.

Most of the value of the preferred interest is attributable to receiving the 7% coupon for 50 years, or until George's death. Stated differently, there is no willing buyer who would pay more than a small amount for the right to receive the par value for the preferred interest on George's death and the reason the preferred interest will have a fair market value of $6,000,000 is because of the right to receive a $420,000 annual preferred coupon.

c. In addition to receiving an upfront charitable income deduction for the present value of the annual coupon of the preferred that is paid to the charity, the donor also receives an indirect second annual deduction with respect to the future preferred coupon payments against his income and health care taxes because of the partnership tax accounting rules.

The preferred interest income that is allocated to the donor advised fund will not be taxed to the other FLLC members because of operation of IRC Sec. 704(b). George will receive each year, in effect, a simulated income tax and healthcare tax deduction for the preferred interest coupon income that is allocated to the donor advised fund (since he will not be taxed on that income). That simulated deduction will not count against his adjusted gross income limitation, and it will not be subject to limitations associated with itemized deductions.

Contrast the double income tax benefit of the charitable gift of the preferred interest coupon with a charitable lead trust in which the donor may either receive a deduction for the actuarial value of the lead interest payable to the charity, or not be taxed on the annual lead payments allocated to the charity, but cannot have *both* income tax advantages.

d. The donor will also avoid the built-in capital gains tax on the sale of any low basis asset that is contributed for the preferred interest.

In this example, George receives his preferred interest in exchange for a transfer of his low basis assets. If the FLLC sells those contributed low basis assets, George should not be liable on any capital gains tax associated with the built-in gain that existed at the time of the contribution, because the gain under IRC Sec. 704(c) should be allocated to the donee, the donor advised fund.

Again, contrast that result with a non-grantor charitable lead trust. If highly appreciated assets are sold by a non-grantor charitable lead trust, the gain will be allocated to the trust. The trust will only receive a deduction for the distributions that are made that year to charity. Thus, in many situations with the use of the non-grantor charitable lead trust, if there are substantial capital gains because of a sale of appreciated assets owed by the trust, that trust will pay a significant capital gains tax.

If instead of a non-grantor charitable lead trust, a “grantor” charitable lead trust is used, the income that results are again disadvantageous. There will not be any allocation of the capital gains to the charitable beneficiary. All of the taxable gain will be allocated to the grantor.

e. Assuming a low basis asset will be sold, the "out of pocket" cost of a gift of a preferred interest to a public charity, or donor advised fund, is minimal because of the above tax advantages.

George asked Pam to compare the benefits of the proposed gift of a preferred FLLC interest with a 7% coupon to making annual cash charitable contributions equal to that 7% coupon and a cash testamentary bequest equal to the par value of the preferred to the donor advised fund at George's death. Additionally, George asked Pam to assume that he will live 20 years, and that if he elects to contribute the preferred interest to charity, the charity's preferred interest will be liquidated at his death.

In order to isolate the benefits of each of the annual giving strategies, Pam assumes George's assets will earn 7% before taxes. George asks Pam to assume 3% of the return will be taxed at ordinary rates and 4% will be taxed at capital gains rates (with 30% annual turnover). Using those assumptions she then calculates the income and health care tax efficiency ratio (present value of both total net income and healthcare tax savings divided by the present value of the total out of pocket cash) under the two assumed scenarios. Pam assumes a 7% present value discount rate. Please *see* Table 10 below and attached Schedule 14.

f. Income tax valuation advantage: IRS concedes preferred partnership interests should have a high coupon.

Prior to passage of IRC Sec. 2036(c) in 1987 (which was repealed in 1990) and prior to the passage of IRC Sec. 2701 as part of Chapter 14 in 1990, the IRS did not have many tools with which to fight, from their perspective, abusive estate freezes, except valuation principles. In 1983, the IRS issued a Revenue Ruling,[145] which promulgated the factors for determining what an appropriate coupon should be on preferred stock of a closely held corporation or what an appropriate coupon should be on a preferred partnership interest in a closely held FLP. Generally, the IRS took the view that a secondary market does not exist for interests in FLPs. Accordingly, with respect to a preferred partnership interest in a FLP, the coupon should be very high in order to reflect the embedded marketability discount of the preferred partnership interest. In other words, according to the IRS, to have a preferred partnership interest valued at "par", a hypothetical willing buyer would demand a significant return on that preferred partnership interest, in comparison to other comparable fixed income instruments, in order to compensate that hypothetical willing buyer for the lack of marketability that would be inherent in that family limited preferred partnership interest.

[145] Rev. Rul. 83-120, 1983-2 C.B. 170.

Table 10

Description	Tax Efficiency Ratio of Charitable Gifts (Present Value of Total Net Tax Savings ÷ Present Value of Total Out of Pocket Cash)
No Further Planning Except for $420,000 Annual Gift to Charity: Bequeaths $6mm to Charity at Death	**20.78%**
Hypothetical Technique: Creation of an FLLC with Growth and Preferred Interests; Gift of a $6,000,000 Preferred Interest to Charity That Pays an Annual 7% Coupon	**70.09%**

g. IRC Sec. 2036 avoidance advantage, if George gives or sells the growth interests to his family.

If the growth member interest is transferred to the donor's family after the preferred member interest is transferred to a public charity IRC Sec. 2036 should not operate to include the transferred common interest (or the underlying partnership assets) in the transferor's gross estate, for two reasons.

First, there is a substantial investment purpose (i.e., non-tax purpose) with having preferred and common interests that divide the economic return of the FLP or FLLC between the owners of the interests in a different way than would result without the two interests. This creates is a substantive investment reason for the creation of the FLP or FLLC. As such, it should constitute a significant non-tax purpose, one that is inherent in the preferred/common structure. This in turn should minimize the danger of IRC Sec. 2036 being applied to any transfers of interests in the FLP or FLLC, because the Tax Court and the Courts of Appeal are much less likely to apply IRC Sec. 2036 to transferred FLP or FLLC interests if a non-tax reason, preferably an investment non-tax reason, exists for the creation of the FLP or FLLC.[146]

Second, the enactment of IRC Sec. 2036(c) (in 1988) and its subsequent repeal (in 1990) demonstrates that going forward Congress intended to address the preferred/common structure solely by means of the gift tax rules of Chapter 14 (IRC Sec. 2701) and *not* by including the

[146] *Estate of Kimbell v. United States, 371 F.3d 257* (5th Cir. 2004); *Church v. United States*, 85 A.F.T.R. 2d (RIA) 804 (W.D. Tex. 2000), *aff'd without published opinion*, 268 F.3d 1063 (5th Cir. 2001) (per curiam), unpublished opinion available at 88 A.F.T.R. 2d 2001-5352 (5th Cir. 2001); *Estate of Bongard v. Commissioner, 124 T.C. 95* (2005); *Estate of Stone v. Commissioner*, 86 T.C.M. (CCH) 551 (2003); *Estate of Schutt v. Commissioner*, T.C. Memo 2005-126 (May 26, 2005); *Estate of Mirowski v. Commissioner*, T.C. Memo 2008-74; *Estate of Miller v. Commissioner*, T.C. Memo 2009-119; *Rayford L. Keller, et al. v. United States of America*, Civil Action No. V-02-62 (S.D. Tex. August 20, 2009); *Estate of Murphy v. United States*, No. 07-CV-1013, 2009 WL 3366099 (W.D. Ark. Oct. 2, 2009); and *Estate of Black v. Commissioner*, 133 T.C. 340 (2009) and *Shurtz v. Commissioner*, T.C. Memo 2010-21.

transferred common interest in the transferor's gross estate under IRC Sec. 2036. The legislative history of the repeal of IRC Sec. 2036(c) unmistakably manifests this Congressional intent. Thus, even if the transfer of the growth interests occurs at the taxpayer's death, because of that strong legislative intent, IRC Sec. 2036 should not apply.

In 1988, the Tax Court in the *Boykin*[147] case ruled that because of state property law,[148] the receipt of income from retained preferred stock is only a retention of income from the preferred stock, not from the assets of the entire enterprise and accordingly should be included in a decedent's estate under IRC Sec. 2033, and not under IRC Sec. 2036. The court concluded that Mr. Boykin did not have a legal retained property right to the income of the assets of the corporation, he only retained a legal right to the income of the retained preferred stock.

In 1988 Congress passed legislation to overturn the result of *Boykin*, IRC Sec. 2036(c). For a very brief period, 1988 to 1990, IRC Sec. 2036(a), when it applied, did operate to include the partnership assets of a partnership in which a preferred partnership interest was created to the exclusion of IRC Sec. 2033. (While IRC Sec. 2033 also could have applied in 1987 to include the same partnership interests, Congress was very careful to reverse the traditional priority of IRC Sec. 2033 inclusion over IRC Sec. 2036 inclusion with the passage of IRC Sec. 2036(c)(5)). In 1988, Congress explored whether or not to do away with minority and marketability discounts with respect to family partnership and family corporations and whether to attack so-called estate freezes. At that time, Congress decided not to attack FLP discounts or discounts associated with family corporations. However, Congress decided to attack so-called estate freezes by making estate freezes that met six defined tests (described in IRC Sec. 2036(c)) subject to the IRC Sec. 2036(a) inclusion.

3. Considerations of the technique.

a. Despite state property law, the IRS may take the position that the gift of the preferred interest of an FLLC should be considered a non-deductible partial gift of the underlying assets of the FLLC.

IRC Sec. 170(f)(3) denies an income tax charitable deduction, and IRC Sec. 2522(a)(2) denies a gift tax charitable deduction, for a contribution of an interest in property that consists of

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[147] *See Estate of Boykin v. Commissioner*, T.C. Memo 1987-134, 53 T.C.M. (CCH) 345.

[148] Under certain Supreme Court holdings, in determining the value for gift and estate tax purposes of any asset is transferred, the legal rights and interests inherent in that transferred property must first be determined under state law. *See United States v. Bess*, 357 U.S. 51 (1958); *Morgan v. Commissioner*, 309 U.S. 78 (1940); s*ee also* H. REP. NO. 2543, 83rd Cong. 2nd Sess., 58-67 (1954); H.R. REP. NO. 1274, 80th Cong. 2nd Sess., 4 (1948-1 C.B. 241, 243); S. REP. NO. 1013, 80th Cong., 2nd Sess., 5 (1948-1 C.B. 285, 288) where the Committee Reports on the 1948 changes in the estate taxation of community property states: "Generally, this restores the rule by which estate and gift tax liabilities are dependent upon the ownership of property under state law." *See also* the reports of the Revenue Act of 1932 that define "property" to include "every species of right or interest protected by law and having an exchangeable value." H.R. REP. NO. 708, 72nd Cong., 1st Sess., 27-28 (1932); S. REP. NO. 665, 72nd Cong., 1st Sess., 39 (1932).

less than the taxpayer's entire interest in such property. A gift of the entirety of an asset or an undivided portion of the taxpayer's entire interest in property to a charity does qualify for the income tax and gift tax charitable deduction. The undivided portion of the taxpayer's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right the decedent owned in the property. IRC Sec. 170(f)(3)(B)(ii) and Treas. Reg. § 1.170A-7(b) provide that a deduction is allowed for a contribution, that is not in trust, of a partial interest that is less than the donor's entire interest in property if the partial interest is an undivided portion of the donor's entire interest. An undivided portion of a donor's entire interest in property must, however, consist of a fraction or percentage of *each and every substantial interest or right* owned by the donor in such property. *See* Rev. Rul. 88-37, 1988-1 C.B. 97 (1988).

The Tax Court in the *Estate of John Boykin*[149] held that an ownership of a preferred equity interest does not entitle the owner to any rights to the assets of the entity – it only entitles the owner to rights in the preferred interest. Any gift of the preferred interest should be analyzed as a gift of the preferred interest not a gift of certain rights over the entity's assets. Consistent with the *Boykin* case cited above, the preferred interest should be considered to be a separate interest both from the FLLC's assets and from George's other interests in the FLLC. The separate preferred interest is transferred in its entirety. In this example, all of George's preferred interest passes to charity – he does not retain any interest in the preferred interest or make a gift of part of the preferred interest, so the transfer is not "a contribution (not made by a transfer in trust) of an interest in property which consists of less than the taxpayer's entire interest in such property." IRC Sec. 170(f)(3).

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[149] *Estate of Boykin v. Commissioner*, T.C. Memo. 1987-134, 53 T.C.M. 345. *See also Hutchens Non-Marital Trust v. Commissioner*, 66 T.C.M. (CCH) 1599 (1993) (The Tax Court held that the interest that the decedent held in his family-owned corporation prior to recapitalization was not includible in his gross estate under IRC Sec. 2036 because the decedent received adequate consideration for the pre-recapitalization stock, the decedent retained no interest in stock surrendered in the recapitalization, and the decedent's post-recapitalization control and dividend rights came from new and different forms of preferred stock that he received in the recapitalization.) *See* also private letter rulings 8950071 (issued on September 21, 1989), 9022010 (issued on February 27, 1990) and 201129033 (issued on July 22, 2011). In each of these private letter rulings the IRS ruled that in the case where a donor owned different classes of corporate stock with different rights, the "partial interest" rule was not violated when only one class of stock was donated to charity. *See also* Todd Angkatavanich, Jonathan G. Blattmachr and James R. Brockway, "Coming Ashore – Planning for Year 2017 Offshore Deferred Compensation Arrangements: Using CLAT's, PPLI and Preferred Partnerships and Consideration of the charitable Partial Interest Rules," 39 ACTEC Law Journal 103, 130-145, 152-153. The authors discuss *McCord v. Commissioner*, 120 T.C. 358 (2003), rev'd and remanded, 461 F.3d 614 (5th Cir. 2006), *Church v. United States*, 85 A.F.T.R. 2d 2000-804 (W.D. Tex. 2000), aff'd 268 F.3d 1063 (5th Cir. 2201), and *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), aff'd in part and remanded in part, 293 F.3d 279 (5th Cir. 2002), on remand 85 T.C.M. (CCH) 1331 (2003), aff'd 417 F.3d 468 (5th Cir. 2005) and conclude that a gift of a preferred interest to a charity should not be considered a gift of a partial interest because the courts follow the entity rule in determining the property rights associated with a partnership interest. The authors also conclude the argument is strengthened if the gift of a preferred interest is made to a qualifying trust (e.g., a charitable lead trust) and/or the donor only owns the donated preferred interest and does not own any other interest in the partnership. (*See* discussion *infra* Section XIII.B.5.)

On the gift tax side (*see* IRC Sec. 2522(c)(2)) there are two Supreme Court cases stating that the gift tax consequences should be applied in a manner that follows a state property law analysis.[150]

State law does not treat a partnership interest as a partial interest in the underlying assets of the partnership. A partner is not a co-owner of partnership property and has no interest in partnership property that can be transferred, either voluntarily or involuntarily. *See* Revised Uniform Partnership Act, § 501. The only transferable interest of a partner in the partnership is the partner's share of the profits and losses of the partnership and the partner's right to receive distributions. Ownership of a partnership interest does not entitle the owner to any rights over property owned by the partnership. Revised Uniform Partnership Act, § 502; *Michtom v. United States*, 573 F.2d 58, 63 (Ct. Cl. 1978); PLR 9825001. Partnerships are distinct entities. Revised Uniform Partnership Act, § 201.

Despite state property law, there is a possibility that the IRS could attempt to deny a charitable deduction for a contribution of preferred units. Treas. Reg. § 1.170A-6(2) allows a deduction for a contribution of a partial interest in property only "if such interest is the taxpayer's entire interest in the property, such as an income interest or a remainder interest." "If, however, the property in which such partial interest exists was divided in order to create such interest and thus avoid IRC Sec. 170(f)(2), the deduction will not be allowed." Id. The IRS may take the position that IRC Sec. 170(f)(3) can apply despite the fact that a contributed interest becomes a separate property interest for federal tax purposes as a result of the transfer. For instance, the IRS has denied charitable deductions in situations where the donor had donated common stock but retained the right to vote that stock (*see* Rev. Rul. 81-281, 1981-2 C.B. 78; PLR 8136025) because the right constitutes a substantial interest. Carving the right to vote away from the economic interest in the common stock created a non-deductible partial interest.

Similarly, in Rev. Rul. 88-37, the IRS denied a deduction because the donor did not contribute the donor's entire interest in his property but carved out and contributed only a portion of that interest. Further, the portion contributed was not an undivided portion of the donor's entire interest—it did not convey a fraction of each and every substantial right owned by the donor in the property. By transferring an overriding royalty interest or a net profits interest, the donor retained the right inherent in the "working interest" (the ownership of an operating interest under an oil and gas lease) to participate in the control of, the development and operation of the lease. This right to control or to participate in the control, similar to the retained voting rights in Rev. Rul. 81-282, is a substantial right, the retention of which prevented the donated interest from being considered an undivided portion.

There are numerous business and financial reasons to form a partnership or FLLC as an advantageous vehicle for, and being in the best interests of, the members of a family, including consolidation of the management and control of family assets within a partnership owned by the eventual owners of all of the assets; avoidance of fractional asset ownership over time; greater

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[150] *See United States v. Bess*, 357 U.S. 51 (1958); *Morgan v. Commissioner*, 309 U.S. 78 (1940).

creditor protection; greater ability to keep assets in the family, etc. The more of these factors that are applicable to any proposed FLLC the less likely the contribution of preferred units will be attacked as a prohibited gift of partial interests.

The proposed FLLC should be created for reasons independent of obtaining a charitable deduction and independent of avoiding section 170(f)(3). The fact that the charitable deduction is likely to be only 30% of the value of the preferred units given away may demonstrate that other reasons are more important than the charitable deduction. The more participants in the FLLC the more likely it was created for purposes independent of obtaining a charitable deduction and the less likely the IRS will deny the charitable contribution as a gift of a partial interest.

Consequently, it is important to establish that the purpose of the FLLC is not to slice the voting rights from the FLLC's underlying securities by retaining the managing units (which control the FLLC and thereby control the vote of the underlying securities) and donating only the preferred units (which carry no control over the FLLC). Having an independent entity from the donor as a manager will strengthen the donor's position.

Another factor that could bolster the argument that the FLLC was not created for purposes only related to dividing the economic interests of the contributed property to the FLLC in order to circumvent the partial interest rule is the longevity of the FLLC before gifts are made to charity. The longer the FLLC exists prior to the contribution, the more a separate purpose would be indicated. *See* Rev. Rul. 86-60, 1986-1 C.B. 302 (four-year delay between creation of partial interest and proposed contribution); Rev. Rul. 76-523, 1976-2 C.B. 54 (1976) (split of interests in stock was for business purpose and done years before the transfer to charity); PLR 20010812 (eight-year delay between the donor's transfer of voting rights in common stock to a voting trust and her charitable donation of that stock); PLR 9721014 (ten-year delay between creation of partial interest and the proposed contribution).

b. If the gift of the preferred interest is to a donor advised fund (instead of some other public charity) care should be taken to make sure there is not a tax on excess business holdings under IRC Sec. 4943.

This example assumes the FLLC owns only financial assets. If the FLLC owns trade or business assets and if the preferred is given to a donor advised fund (instead of some other public charity) the excess business holding rules need to be considered. *See* IRC Sec. 4943(b).

c. The taxpayer must comply with certain reporting requirements in order to receive a deduction for the fair market value of the donated preferred interest.

Among the reporting requirements are:

(1) The taxpayer must get and keep a contemporaneous written acknowledgment of the contribution from the charity. *See* IRC Sec. 170(f)(8)(A).

(2) The taxpayer must also keep records that include how the taxpayer acquired the property and the basis information for the donated preferred interest. *See* Treas. Reg. §§ 1.170A-13(b)(3)(i)(A), (B).

(3) The taxpayer must also obtain a qualified written appraisal of the donated property from a qualified appraiser, if the preferred interest is worth more than $500,000 attach the qualified appraisal to the taxpayer's return. *See* IRC Sec. 170(f)(11)(D).

d. If there is unrelated business taxable income associated with assets owned by the FLLC, some public charities will not accept the gift of the preferred interest in the FLLC.

All items of income of the FLLC will be proportionately allocated to the owner of the preferred interest, including items of income that are considered unrelated business income, which will be subject to the unrelated business income tax under IRC Sec. 511. The unrelated business income tax is imposed on the unrelated business taxable income of most exempt organizations. Gross income subject to the tax consists of income from a trade or business activity, if the business activity is not substantially related to the charity's exempt purposes and is regularly carried on by the organization. Even passive income, such as dividends and interest, will be subject to the tax, if the income is derived from debt-financed property.

C. The Use of a High-Yield Preferred Partnership or Membership Interest With a CLAT.

1. What is a CLAT?

a. A CLAT is a trust in which the lead interest is payable to a charity and is in the form of an annuity amount for the term of the lead interest.

b. In the CLAT, the annual payment is not based on the income of the trust. Since the annuity amount is not based on the income of the trust, that amount must be paid to the charity even if the trust has no income. If the trust's current income is insufficient to make the required annual payment, the short fall must be made up out of the invasion of the trust principal. If the current income exceeds the required annual payment, it does not have to be paid over to the charity; however, the excess income would then be accumulated and added to the trust corpus.

c. The lead interest in a CLAT can be for a fixed term of years. Unlike a charitable remainder trust, the fixed term can be

indefinite.[151] The lead interest can also be measured by the life of an existing individual or the joint lives of existing individuals.

d. CLATs are not subject to the minimum payout requirements associated with charitable remainder trusts. Thus, there is no 5% minimum pay out for CLATs.

e. The CLAT is not a tax-exempt entity, unless the CLAT is a grantor trust. If the CLAT is a non-grantor trust and if taxable income is accumulated in the trust it will be subject to income taxes. The CLAT will receive a charitable income tax deduction when it makes the distribution to the charity. If the CLAT is a grantor trust, the grantor will receive an income tax deduction for the actuarial value of the charitable gift of the annuity amounts upon creation of the CLAT. If the CLAT is a grantor trust, there will not be any future income tax deductions for distributions to charities.

f. CLATs are characterized as private foundations for purposes of certain restrictions placed on such organizations. Accordingly, CLATs are subject to private foundation excise tax provisions.[152] The governing trust instrument must contain specific prohibitions against (i) self-dealing; (ii) excess business holdings; (iii) jeopardy investments; and (iv) taxable expenditures.[153] If the specified prohibited transactions occur onerous significant excess taxes could accrue.

2. The technique.

What if a financial engineering technique existed that would generally ensure the financial success (from the remainderman's perspective) of a CLAT and would create additional discounts for any future non-charitable gifts to family members? Consider the following example:

If a taxpayer creates a preferred interest in a FLP or a FLLC and contributes that preferred interest to a CLAT, the success of the CLAT is virtually assured. This is because all of the assets and the income of all of the assets of the FLP or FLLC are available to ensure the success of the coupon payments that are made on the preferred interest that is contributed to the CLAT. Assuming the preferred coupon rate is substantially in excess of the IRC Sec. 7520 rate, substantial assets will be available to the remainder beneficiaries of the CLAT on its termination.

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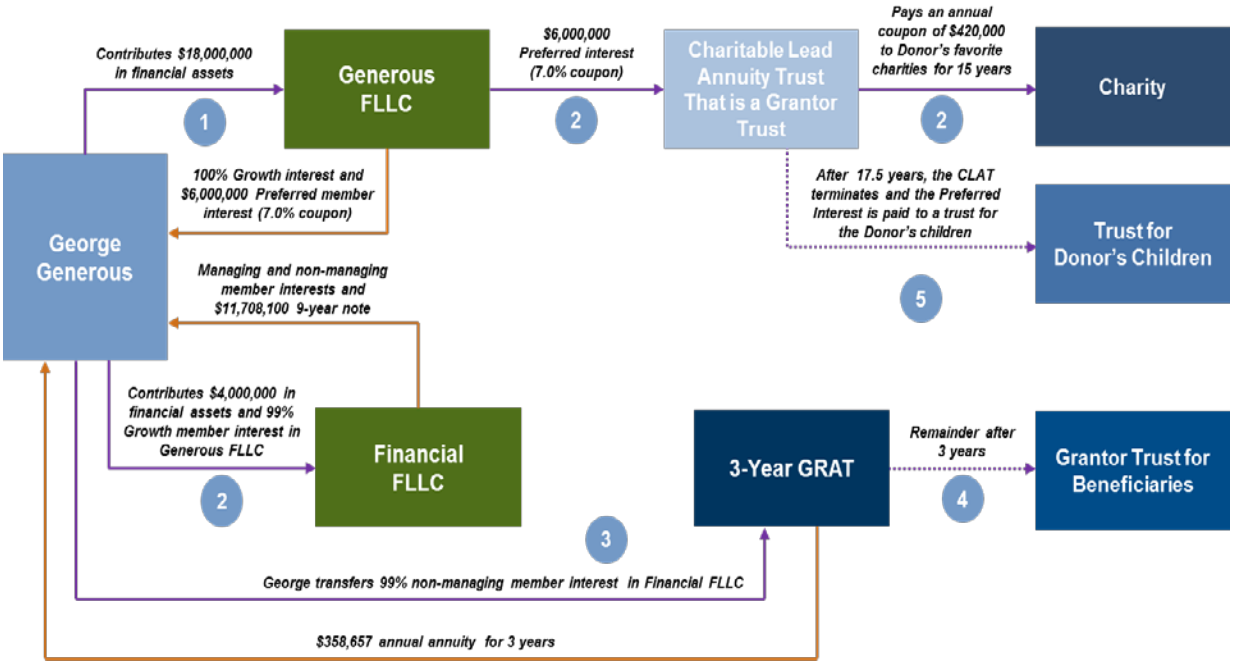
[151] IRC Sec. 170(f)(2)(B).

[152] IRC Sec. 4947(a)(2).

[153] *See* IRC Secs. 4941(a)-(b), 4943(a)-(b).

Consider the following Example 17, which has the same facts as Example 21, except the gift of the preferred interest is a 17.5-year CLAT that is treated as a grantor trust:



3. Income tax advantages of the technique.

   a. The donor will not pay income taxes or healthcare taxes on income that is allocated to the CLAT, if the CLAT is a conventional CLAT and is not a grantor trust.

See discussion *supra* Section XII.C.1.

   b. The donor will receive an upfront deduction against income taxes for the actuarial value of the annuity interest paid to charity if the CLAT is a grantor trust.

4. Considerations of the technique.

   a. The partial interest rule should not apply for gift tax purposes or income tax purposes (if a grantor CLAT is used), but the IRS may make the argument.

The income tax deduction is obviously unimportant if a non-grantor CLAT is used, because the gift on the annuity in a non-grantor CLAT is not eligible for an income tax deduction. What if the CLAT is a grantor trust? It is then important to receive an upfront income tax deduction. The question then becomes whether IRC Sec. 170(f)(3), which denies a charitable deduction for a contribution to charity (not made by a transfer in trust) of certain partial interests in properly, trumps the deduction allowed under IRC Sec. 170(f)(2) for gifts to grantor CLATs. The answer should be no.

In addition to the arguments and analysis *supra* Section XII.B.4, there is the additional benefit of having the gift structured as a gift of an annuity interest in a charitable lead annuity trust. The sought-after deduction is not for the contribution of the partial interest to the trust, but rather for the contribution of the term interest in the trust to charity. The deduction must be allowable "*with respect to the trust*," not with respect to the assets contributed to the trust. The charitable deduction is specifically allowed by IRC Sec. 170(f)(2) for the contribution of the term interest in the grantor lead trust. Here, the deduction is allowable with respect to the grantor lead trust as long as the grantor lead trust otherwise meets the description of IRC Sec. 664. Second, IRC Sec. 170 (f)(3) specifically refers to contributions "not made by a transfer in trust", whereas IRC Sec. 170(f)(2) refers to contributions "in trust." IRC subsections 170(f)(2) and 170(f)(3) are mutually exclusive: the first applies to contributions in trust and the second applies to contributions outside of trust.

Concerns about the partial interest issue arise from Private Letter Ruling 9501004. This ruling involved a charitable trust funded with an option to purchase real estate. The donor contributed an option to purchase real estate instead of contributing real estate itself because the real estate was encumbered by debt. According to the ruling, an option does not, before exercise, vest in the optionee any interest, estate or title in the land. Accordingly, the taxpayer would not be allowed a charitable deduction in the year in which the option was granted but would be allowed a deduction in the year in charitable organization exercised the option. *See* Rev. Rul. 82-197, 1982-2 CB 1982).

In that ruling, the IRS disregarded the specific language of Treas. Reg. § 1.664-l(a)(l)(iii). That section defines qualified charitable remainder trusts as *trusts* for which an income or transfer tax deduction is *allowable*. It does not require that each contribution to a trust must be independently deductible in order for the trust to qualify. As justification for ignoring this distinction, the IRS relies upon its "function exclusively" weapon of Treas. Reg. § 1.664-l(a)(4), which requires that the charitable remainder trust at all times throughout its existence must "meet the definition of and function exclusively as a charitable remainder trust." Using this weapon, the IRS read into IRC Sec. 1.664-l(a)(l)(iii) a requirement that each asset contributed to the trust must independently qualify for a charitable deduction under IRC Secs. 170, 2055, 2106 or 2522 in order for the trust to be, and to function exclusively as, a charitable remainder trust "in every respect." There is no direct authority to support this argument as there is no direct authority regarding what constitutes meeting the definition of and functioning exclusively as a charitable remainder trust.

Based on this questionable interpretation of the statute and the regulation's language, the IRS proceeded to discuss the denial of the income tax deduction based on the partial interest rule of IRC Sec. 170(f)(3). The IRS posited an example where the property contributed to the trust ultimately passed outside the trust: the facts in the ruling indicated that the option would never be exercised by a charitable organization or trust, but rather would be assigned to a third party. Then, relying on the partial interest rule of IRC Sec. 170(f)(3) (not 170(f)(2)), the IRS denied the income tax deduction because the contribution was of a partial interest which passed *outside* of the trust. The ruling goes out of its way to say: "However, no deduction would be allowable under [the partial interest rule] for any payment made to such a third party purchaser that

purchases and exercises the purported option. In such a situation, the payment by Taxpayer would be made to the third party charitable organization *outside the trust* [emphasis added]."

That statement would not be necessary if the option itself, as a partial interest, disqualified the trust.

It is also important for purposes of the gift tax charitable deduction whether the partial interest rule applies. As discussed below, the partial interest rule should also not apply for gift tax purposes. Even if the income tax deduction is denied under IRC Sec. 170, the CLAT still qualifies for a gift tax deduction because a gift tax deduction remains allowable under IRC Sec. 2522. IRC Sec. 2522 does not appear to incorporate a 170(f)(3)-type partial interest rule. PLR 9501004 did not address whether IRC Sec. 2522 indirectly incorporates a partial interest rule because the gift was found to be incomplete. "Such [an incomplete] transfer would not constitute a transfer to the Trust for which a gift tax charitable deduction is allowable with respect to the Trust." The converse is implied to be true - if the payment by Taxpayer would be made to a charitable organization inside a trust, such a transfer would constitute a transfer for which a gift tax charitable deduction is allowable with respect to the trust.

The IRS did not import a 170(f)(3)-type partial interest rule into IRC Sec. 2055 in its private letter ruling 200202032. In that ruling, the taxpayer had previously contributed to the museum all of his right, title and interest in and to a 50% undivided interest in 32 paintings. At his death, the taxpayer bequeathed his remaining 50% undivided interest in the 32 paintings to the museum. The ruling held that the taxpayer's 50% undivided interest qualified for the estate tax charitable deduction under IRC Sec. 2055, despite being partial interests.

IRC Secs. 170(f)(2), 170(f)(3), 2055(e)(2) and 2522(c)(2) were enacted as part of a comprehensive revision of the tax treatment of charitable contributions in the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487. In that legislation, Congress provided rules governing charitable gifts of partial interests outside of trust, *see* IRC 170(f)(3); income tax deductions for gifts in trust, *see* IRC Sec. 170(f)(2); estate tax deductions, *see* IRC Sec. 2055(e)(2), and gift tax deductions, *see* IRC Sec. 2522(c)(2). Notably, Congress did not include a corresponding IRC Sec. l70(f)(3)-like provision in IRC Secs. 2055 or 2522.

The legislative history concerning income tax deductions for gifts of partial interests not in trust weighs against importing the same restrictions into IRC Secs. 2055 and 2522. The history focused on the practice of taking a deduction for the donation of the rent-free use of property for a specified time. Congress agreed with the IRS's position that in such a situation a taxpayer obtains a double benefit by being able to claim a deduction for the fair rental value of property and also exclude from income the receipts from the donated interest during the period of the donation. The legislative solution was to permit the exclusion but deny an income tax deduction. *See* H.R. Rep. No. 413, 91st Cong., 1st Sess. 57-58 (1969), 1969-3 C.B. at 239. This solution is not relevant in the transfer tax context.

b. Care should be taken to make sure that there is not a tax on excess business holdings under IRC Sec. 4943.

This example assumes the FLLC owns only financial assets. If the FLLC owns a trust or business, since the CLAT will be considered a private foundation, the excess business holding rules and IRC Sec. 4943 need to be considered.

c. If the CLAT is a grantor trust the grantor will pay the income taxes on the earnings of the CLAT.

However, from a transfer tax planning point of view, that is generally advantageous.

D. Planning for Gifts of Art to a Private Foundation That Will Eventually Be Sold By That Private Foundation.

1. The technique.

If a taxpayer wishes to give his private foundation some artwork, which will eventually be sold, that taxpayer is faced with the prospect of very little tax subsidization. If the taxpayer first sells the art and then gives cash to his private foundation, the taxpayer will get a charitable deduction for the value of the cash (subject to A.G.I. limits) that is contributed to the private foundation (Technique 1 in the table below). However, the taxes on the sale of the artwork could be very steep. If a taxpayer sells art the appreciation of the art will be taxed at a federal income tax rate of 28%. If the taxpayer does not sell the artwork but instead contributes it to his foundation, which then sells the artwork, the taxpayer will avoid the 28% tax on the appreciation of the artwork (Technique 2 in the table below). However, the taxpayer will only receive an income tax charitable deduction equal to his basis in the artwork.

Is there a technique that could closely simulate the tax result that would occur if a taxpayer could both receive an income tax deduction for the full fair market value of the artwork he contributes to his foundation and also not be taxed on the sale of the artwork by the foundation? There may be. Consider using the NIMCRUT technique in light of IRC Sec. 170(a)(3), which provides as follows:

> (3) FUTURE INTERESTS IN TANGIBLE PERSONAL PROPERTY.—For purposes of this section, payment of a charitable contribution which consists of a future interest in tangible personal property shall be treated as made only when all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired or are held by persons other than the taxpayer or those standing in a relationship to the taxpayer described in section 267(b) or 707(b). For purposes of the preceding sentence, a fixture which is intended to be severed from the real property shall be treated as tangible personal property.

An example of the technique follows:

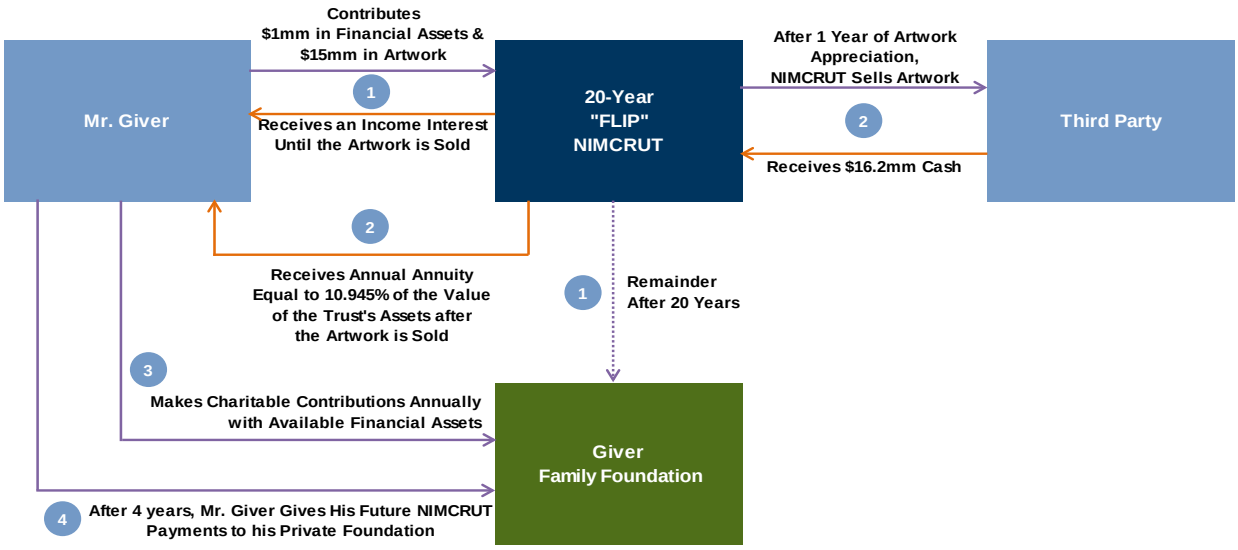
Example 18: Art Giver Contributes His Artwork Worth $15,000,000 and $1,000,000 in Financial Assets to a NIMCRUT in Which the Remainderman is a Private Foundation

Art Giver wishes to increase the endowment of his private foundation. Art has some appreciated art worth $15,000,000, which could be sold. The proceeds of the art sales could be used by Art's foundation to increase its endowment. Art asks his tax advisor, Pam Planner, what would be the most efficient way to accomplish his goals?

Pam suggests the most efficient way to endow Art's foundation may be to contribute the $15,000,000 in artwork and $1,000,000 in financial assets to a 20-year "flip" NIMCRUT. The terms of the NIMCRUT could provide that Art would only be entitled to the income of the NIMCRUT until the art is sold. When the artwork is sold Art will be entitled to receive an annual unitrust payment.

Art tells Pam to assume that one year after the NIMCRUT is created the trustee will find a buyer for the art. It is assumed that the artwork will appreciate 8% during that one-year period and, hence, that the artwork will have a value of $16,200,000 when it is sold. It is also assumed that the IRS Sec. 7520 rate will be 2.6% and the annual payout of the NIMCRUT will be 10.945% of the then value of the NIMCRUT after the artwork is sold. Art also tells Pam that, assuming he can afford it, he plans to contribute his NIMCRUT net cash flow from his term interest to his foundation, after reserving enough to pay his income taxes associated with the NIMCRUT distributions. Art further tells Pam to assume he has a 10-year life expectancy. Pam also assumes that in four years Art may be comfortable enough with his other consumption sources that he may give away his right to receive future NIMCRUT payments to his foundation. Art's basis in the $15,000,000 of artwork is $4,500,000 and his basis in the $1,000,000 of financial assets is $1,000,000.

A diagram of the technique is below:



2. Income tax advantages of the technique.

a. Because of the operation of IRC Sec. 170(a)(3), the charitable income tax deduction associated with the remainder value of the artwork may be postponed until the art is sold by the NIMCRUT and the deduction may be determined by using the sale proceeds at the moment the remainder gift is complete.

The argument is that the contribution of the artwork is not complete, because of operation of IRC Sec. 170(a)(3), until the artwork is sold and the cash proceeds are received. When the contribution is finally complete (thanks to the IRC Sec. 170(a)(3) suspension) it is a gift of cash, not tangible property for an unrelated use. The regulations under IRC Sec. 664 suggest that in certain circumstances, IRC Sec. 170(a)(3) will apply to gifts made to a charitable remainder trust. For example, the regulations state in part: "For rules for postponing the time for deduction of a charitable contribution of a future interest in tangible personal property, see section 170(a)(3) and the regulations thereunder."[154] Under that analysis Art's income tax deduction for the actuarial value of the NIMCRUT remainder interest is postponed until the artwork is sold.[155] The remainder interest charitable income tax deduction on the value of the cash proceeds from the sale will, in many cases, be much higher than the basis. However, the IRS may resist the finding that the deduction for the remainderman is the net proceeds value and instead take the position that the actuarial deduction for the remainder interest is limited to the then remainder actuarial value of the basis. *See* discussion *supra* Section XII.D.3.b. In the table below, please compare Technique 3, Scenario A (the taxpayer is able to use the sale proceeds to determine the actuarial value of the remainder interest gift when the art is sold) to Technique 3, Scenario B (the taxpayer is only able to deduct the actuarial value of the basis of the art with respect to the remainder interest when the art is sold).

b. The taxpayer has all of the advantages of using a NIMCRUT.

Among the advantages of using a NIMCRUT is that there will not be any immediate capital gains tax on the sale of the artwork. The recipient will only pay that tax on a delayed basis under the tiered income tax rules when the other classes of income have been used in the payout of the unitrust payments.

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[154] IRC Secs. 1.664-2(d), -3(d).

[155] *See* IRC Sec. 170(a)(3). Since under the assumed facts the artwork is sold at the end of one year, the actuarial value of the remainder gift is 11.222% at that time, because only 19 years remain in the term of the NIMCRUT. Art will, however, be able to claim a 10% income tax deduction in the year of the contribution for the actuarial value of the NIMCRUT remainder interest attributable to the $1 million of financial assets contributed to the trust, because 20 years remain in the term of the NIMCRUT when the NIMCRUT was created.

c. The taxpayer will receive a charitable income tax deduction for the transfer of his term interest in the NIMCRUT equal to its actuarial value at the time of the transfer, if the taxpayer's gift is not pre-arranged at the time of the creation of the NIMCRUT.

As the tables below illustrate, using the facts of this example, if the taxpayer no longer needs the cash flow from his term interest and can afford to transfer his term interest to the same charitable recipient as his remainder gift, the taxpayer almost simulates the same result that would occur if there was a subsidized tax holiday (i.e., the same consequences that would occur if the taxpayer could receive a charitable income tax deduction equal to the cash value of the artwork contributed to the foundation coupled with the taxpayer not paying any taxes on the sale of the artwork).

As illustrated by Table 11a below (also see attached Schedule 15), from the point of view of the charity, there is a only a 6.01% decrease in the results of a simulated tax holiday, if the taxpayer is able to use the sale proceeds to determine the actuarial value of the remainder interest gift (Technique 3, Scenario A). Also, as illustrated by Table 11a below (also see attached Schedule 15), there is an 8.92% decrease in the results of a simulated tax holiday, if the taxpayer is only able to deduct the actuarial value of the basis of the art with respect to the remainder interest (Technique 3, Scenario B).

Table 11a

From the Point of View of the Charity
Simulated Tax Holiday vs. No Further Planning Techniques vs. Hypothetical Techniques Under Two Different Scenarios
Summary of Hypothetical Results of $16,000,000 of Assets
Post Death Scenarios Assuming Mr. Giver Has a Life Expectancy of 10 Years

	Charity (1)	IRS Income Tax		IRS Estate Tax (at 40.0%) (4)	Value of Art Sale Proceeds Plus $1mm (5)
		Direct Cost/ (Benefit) (2)	Investment Opportunity Cost/(Benefit) (3)		
10-Year Future Values					
Simulated Tax Holiday	$48,918,504	($10,955,058)	($7,532,668)	$0	$30,430,777
No Further Planning Technique #1	$40,821,195	($6,156,930)	($4,233,488)	$0	$30,430,778
No Further Planning Technique #2	$36,785,934	($3,765,801)	($2,589,355)	$0	$30,430,778
Hypothetical Technique #3, Scenario A	$45,978,246	($10,842,512)	($4,704,957)	$0	$30,430,778
Hypothetical Technique #3, Scenario B	$44,553,902	($9,943,734)	($4,179,391)	$0	$30,430,778
Present Values (discounted at 2.5%)					
Simulated Tax Holiday	$38,215,057	($8,558,074)	($5,884,508)	$0	$23,772,475
No Further Planning Technique #1	$31,889,453	($4,809,784)	($3,307,194)	$0	$23,772,475
No Further Planning Technique #2	$28,737,113	($2,941,838)	($2,022,800)	$0	$23,772,475
Hypothetical Technique #3, Scenario A	$35,918,133	($8,470,153)	($3,675,505)	$0	$23,772,475
Hypothetical Technique #3, Scenario B	$34,805,437	($7,768,029)	($3,264,933)	$0	$23,772,475

As illustrated by Table 11b below (also see attached Schedule 15), from the point of view of Art Giver, there is only a 7.17% decrease in the results of a simulated tax holiday, if the taxpayer is able to use the sale proceeds to determine the actuarial value of the remainder interest gift (Technique 3, Scenario A). Also, as illustrated by Table 11b below (also see attached Schedule 15), from the point of view of Art Giver, there is only a 15.17% decrease in the results of a simulated tax holiday, if the taxpayer is only able to deduct the actuarial value of the basis of the art with respect to the remainder interest (Technique 3, Scenario B).

Table 11b

From the Point of View of Art Giver
Simulated Tax Holiday vs. No Further Planning Techniques vs. Hypothetical Techniques Under Two Different Scenarios
Summary of Hypothetical Results of $16,000,000 of Assets
Post Death Scenarios Assuming Mr. Giver Has a Life Expectancy of 10 Years

	Net Present Value (discounted at 2.5%)		
	Charitable Income Tax Savings	Capital Gains Tax on Sale of Art	Income Tax Benefit of Strategy
	(1)	(2)	(1)-(2)
Simulated Tax Holiday[1]	$10,501,473	$0	$10,501,473
No Further Planning Technique #1[2]	$9,098,105	$3,196,098	$5,902,007
No Further Planning Technique #2[3]	$3,609,882	$0	$3,609,882
Hypothetical Technique #3, Scenario A[4]	$11,307,999	$1,558,973	$9,749,026
Hypothetical Technique #3, Scenario B[5]	$10,467,410	$1,558,973	$8,908,437

(1) Simulated Tax Holiday - Mr. Giver receives a full deduction for giving cash and art to his foundation; foundation may sell the art without any capital gains tax attributable to Mr. Giver; Mr. Giver makes annual gifts to charity to the extent that he has extra cash.

(2) No Further Planning Technique #1 - sale of art; net proceeds from sale of art after taxes contributed to foundation; annual gifts to charity to the extent that Mr. Giver has extra cash.

(3) No Further Planning Technique #2 - art contributed to foundation; deduction limited to art basis; foundation sells art; annual gifts to charity to the extent that Mr. Giver has extra cash.

(4) Hypothetical Technique #3, Scenario A - art contributed to a flip NIMCRUT; net proceeds of NIMCRUT distributions plus available cash are annually contributed to foundation; Mr. Giver receives a deduction for remainder interest of NIMCRUT when art is sold equal to sale proceeds.

(5) Hypothetical Technique #3, Scenario B - art contributed to a flip NIMCRUT; net proceeds of NIMCRUT distributions plus available cash are annually contributed to foundation; Mr. Giver receives a deduction for remainder interest of NIMCRUT when art is sold equal to basis of art.

d. There will be no estate tax on the art sale proceeds passing to the private foundation.

e. The income tax savings from the technique will increase that part of the taxpayer's assets available for distribution to the taxpayer's non-charitable beneficiaries.

3. Considerations of the technique.

a. For the trust to be a qualified charitable remainder trust, it may be necessary for some deduction to be allowed at the time the trust is created.

Treas. Reg. §1.664-1(a)(1)(iii)(a) may require that a charitable income or gift tax deduction be allowed at the creation of the NIMCRUT.[156] If the only assets in the NIMCRUT are tangible personal property assets (e.g., the artwork), which is subject to IRC Sec. 170(a)(3), the charitable remainder trust may not be qualified. Perhaps the easiest way to satisfy this requirement is for the grantor of the NIMCRUT to also contribute assets that are not subject to IRC Sec. 170(a)(3), such as financial assets. Alternatively, if the grantor does not retain a power to change the remainderman interest, and the remainder interest is a completed gift, a gift tax deduction will be allowed, as there is no "delay" provision comparable to IRC Sec. 170(a)(3) under the gift tax.

b. In order to get the benefit of the delayed deduction for the remainder interest in the NIMCRUT at the full cash value of the remainder interest it may be important that the delayed deduction not be treated as capital gain property.

LTR 9452026 seems to hold that the sale by the NIMCRUT is in itself an unrelated use, regardless of what use the remainderman of the NIMCRUT might make of the property. The result in LTR 9452026 is a deduction for an actuarial share of basis only. Even if the art is treated as related use property, if the delayed deduction is deemed to consist of the art, rather than the sale proceeds, the deduction may be limited to basis because the art is capital gain property transferred to a private non-operating foundation. However, when the grantor assigns the remaining term interest to the remainderman, the reduction would apply only to the extent that the reinvested sale proceeds had appreciated, and there should be no reduction if the trust assets are liquidated prior to the assignment.

c. It is important, under rev. rul. 86-60, for the assignment of the remaining term interest in the NIMCRUT to be eligible for the gift tax charitable deduction that there not be any secondary non-charitable interests.

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[156] *See* LTR 9532006.

d. In calculating the donor's deduction, the assignment must be valued actuarially under IRC Sec. 664 using unitrust valuation based on the trust's stated payout rate, and not limited to the value of an income interest under IRC Sec. 7520.

The recent amendments to IRC Sec. 664(e) seem to support that result, even if a NIMCRUT that does not "flip" to ordinary CRUT status is used.

E. Using the technique of contributing a preferred interest in a family limited partnership to a NIMCRUT in combination with the LAIDGT technique.

Example 19: Sam Saint Contributes a Deferred Coupon Preferred Partnership Interest Interest to a NIMCRUT in Combination With the LAIDGT Technique in Order to Save Income and Transfer Taxes

Sam Saint is very wealthy. A significant part of his $150,000,000 portfolio ($100,000,000) is in Growing, Inc. stock (a publicly traded stock). Sam has no basis in his shares of Growing, Inc. stock. Sam would like to diversify out of that stock in a tax efficient manner. Sam and his family need very little cash flow from that part of his portfolio (Growing, Inc.) for at least 20 years. Sam would like to see approximately 18% of the future value of his then projected estate (before estate taxes) pass to his favorite charities with the rest of his estate passing to his family. Sam is also interested in strategies that will allow him to diversify, in a tax-efficient manner, his highly appreciated Growing, Inc. stock. Sam would like to minimize his gift and estate taxes. Sam asks his tax advisor, Pam Planner, for a suggestion.

Pam Planner suggests contributing a preferred limited partnership interest in an investment partnership to a NIMCRUT in conjunction with the LAIDGT technique to effectuate Sam's goals.

1. The Technique.

a. What is a NIMCRUT?

A charitable remainder unitrust (CRUT) makes distributions to one or more noncharitable beneficiaries for the lifetime of the beneficiary or a fixed period of years. The amount of the distribution is equal to a fixed percentage of the fair market value of the trust assets valued annually. Like other forms of charitable remainder trust, the payout rate must be at least 5% and cannot exceed 50%. The value of the initial gift to charity must be at least 10%. As of August 1, 2018 a 20-year CRUT with an 11.104% unitrust annual payout will satisfy the 10% rule. *See* a further discussion of a CRUT *supra* Section XII.A.

The Net Income with Make-up CRUT (NIMCRUT) is a form of a CRUT that provides that the noncharitable beneficiary will receive the lesser of the designated percentage payout amount or the net income earned by the trust. In addition, if the net income of the trust in any year is less than the percentage payout amount, the trustee is required to make-up the deficiency in a subsequent year when the net income exceeds the percentage amount.

A NIMCRUT is typically recommended when the trust is initially funded with hard to value assets or assets that do not produce significant income. The ability to pay out the lesser of the income or the stated percentage enables the trustee to retain assets in the trust rather than pay out in kind to satisfy the payout requirement.

The ability to delay receipt of any significant payout from the trust enables a donor to build value in the trust and obtain a larger payout in later years when income stream is desired or needed.

The ability to allocate capital gains to income increases the likelihood of successfully making up the deficiency between net income and the payout percentage.

A NIMCRUT is not viable for donors with an immediate need for income distributions from the trust. A NIMCRUT is also not viable if unrelated business income investment problem. It also has the unfavorable tiered income rules. NIMCRUTs designed to last for the life of the noncharitable beneficiary carry the risk that the deficiency account will not be "made up." A NIMCRUT is non-amendable and irrevocable.

b. Gift of a preferred partnership interest or a limited liability company preferred interest to a NIMCRUT.

Sam could transfer his appreciated security (Growing, Inc.) that has a value of $100,000,000 to a new partnership or limited liability company (hereinafter, "LLC")[157] in exchange for three types of units: managing units, preferred units and residual units. No holder of preferred units could withdraw from the LLC, until its termination. The three types of units will have the following characteristics:

The managing units ($1,000,000 capital account) will have a 1% interest in the profit, loss and capital of the LLC. The managing units will elect the manager of the LLC who will make all of the investment and operating decisions for the LLC. The managing units will receive 1% of any distribution and will be required to contribute 1% of any capital contribution. Accordingly, the managing units will be allocated 1% of any tax item. Initially the managing units may have a discounted value of $700,000.

The preferred units will share in the remaining 99% of the LLC's profit, loss, capital and tax items up to preferred coupon. The preferred units ($70,000,000 capital account) resemble preferred stock in that the units will have a fixed liquidation value and carry a payment right of a fixed percentage of that value. Like a preferred stock the preferred payments can be made only out of net income and appreciation of the LLC. The rate on the preferred units will be set at market by an appraisal so that at the time the NIMCRUT is created the market value and the liquidation value of the preferred units is the same. It is assumed for purposes of this example

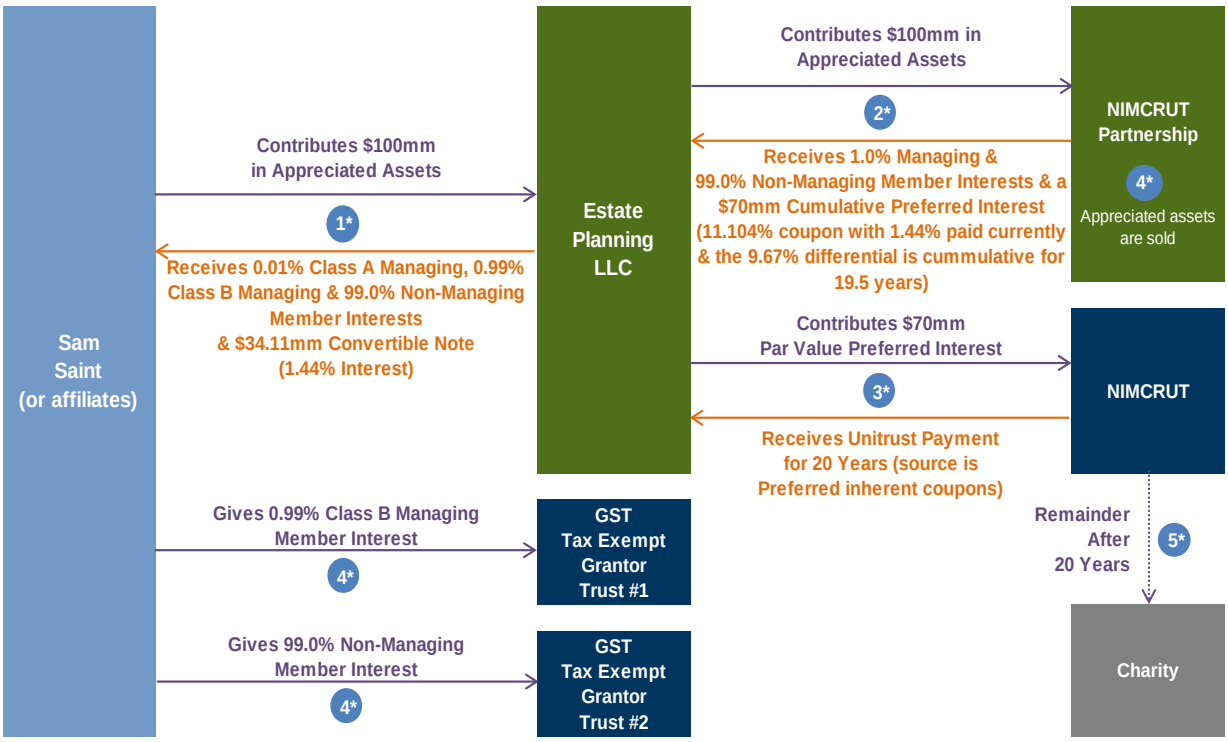
[157] The LLC is taxed as a partnership for federal income tax purposes pursuant to Treas. Reg. §301.7701-3. Accordingly, the LLC sometimes is referred to as a "partnership," and its members, "partners," although not their respective titles under state law.

that a mezzanine preferred return of 11.104% would support par value of the preferred.[158] The unitrust payout rate would be set at a rate to insure a 10% charitable deduction. As of July 29, 2018, the maximum unitrust payout for a 20-year NIMCRUT is 11.104% to insure a 10% charitable deduction. The preferred units would have the first claim on profits to the extent of the unpaid preferred payments prior to any distributions to residual unitholders. The preferred units would have the first claim on capital to the extent of the liquidation value. The liquidation value of the preferred units would equal $70,000,000. The preferred units would not be callable prior to the liquidation of the LLC. However, the LLC would be subject to mandatory dissolution on a fixed date approximately 19-½ years in the future. At such time, the preferred units would be paid their liquidation value plus any unpaid preferred payments, to the extent that the LLC's assets are sufficient to make such payments.

The residual units will share in the LLC's profit and capital after the interests of the managing units and preferred units. The residual units ($29,000,000 capital account) resemble common stock in that way. Profits will be allocated to the residual units only to the extent the cumulative tax profits exceed the cumulative preferred payments. Losses, on the other hand, will be allocated to the residual units to the extent of the original value of those units, plus any undistributed profits. Although the residual units would have an initial liquidation value of $29,000,000, the market value of these highly leveraged units is likely to be discounted by 30% to 40%.

Sam could use the LAIDGT technique in conjunction with this technique. Sam and his family could create a partnership or an LLC ("NIMCRUT Partnership" in the illustration below). Sam could contribute his shares of Growing, Inc. to the NIMCRUT Partnership in exchange for a preferred interest and a growth interest. Assume approximately 70% of the partnership interest that Sam receives is a preferred partnership interest that pays an 11.104% coupon. The coupon will be cumulative with 1.44% paid currently and the 9.67% differential is paid in 19.5 years. The preferred interest could be contributed to a 20 year NIMCRUT. Sam could contribute his respective NIMCRUT Partnership interests and his interest in the NIMCRUT to an Estate Planning LLC, in which the LAIDGT technique is used. Sam could retain a convertible note in Estate Planning LLC and give the units in Estate Planning LLC to GST trusts (i.e., he could use the LAIDGT technique described *supra* Section IV). After the LAIDGT technique is implemented the NIMCRUT partnership could sell the Growing, Inc. stock. For instance, consider the following illustrated Example 19:

[158] Under the valuation concepts of Rev. Rul. 83-120, 1983-2 CB 170, the preferred coupon rate will be very high, because of the preferred partnership interest's inherent lack of voting control, lack of marketability and longevity.



*Transactions need to be separate, distinct and independent.

The payment of the unitrust amount each year would be subject to the NIMCRUT having accounting income during the year. The NIMCRUT would provide for a make-up payment when the trust receives accounting income to the extent the unitrust amount has not been fully satisfied in each prior year.

The NIMCRUT would provide that any distribution from a partnership or limited liability company, other than a return of capital invested, would be accounting income. This would include a distribution of capital gains. If the NIMCRUT Partnership makes only payments to the preferred units equal to 1.44% until the preferred units are redeemed upon liquidation of the NIMCRUT Partnership it is expected that the NIMCRUT would only have accounting income equal to the preferred distribution of 1.44% until such time. Thus, the unitrust amount would accumulate until redemption and then be paid in full. If the unitrust amount and the preferred payments were exactly the same, then the $70,000,000 par liquidation value of the preferred units will go to charity when the NIMCRUT terminates the following year.

The NIMCRUT will calculate the unitrust amount payable to the non-charitable beneficiary based on a fixed percentage of the market value of its assets, consisting of the preferred units valued on the initial day of each year. An appraisal will be required each year to redetermine the market value of the preferred units if those units have a fixed rate. Alternatively, the preferred rate can be reset annually so that the market value of the preferred units equals their liquidation value.

2. Advantages of the technique:

a. In this example, seventy percent of the gain, if LLC sells the securities, should be allocated to the NIMCRUT.

IRC Sec. 704(c)(1)(A) provides generally that if a partner contributes to a partnership property with a fair market value that differs from its tax basis, then income, gain, loss and deduction with respect to that property must be shared among the partners in a manner that takes into account that difference. Thus, for example, assume partner A contributes to a partnership property having a $0 basis and a $100 value. While such a contribution would generally be tax-free when it was made, the $100 of "built-in gain" inherent in the contributed property must be allocated to Partner A (rather than among all the partners) when the property is sold. Similar adjustments must be made in the case of depreciable property (e.g., by allocating a certain amount of depreciation deductions away from the contributing partner).

If a partner contributing "built-in gain" property transfers its partnership interest, then the IRC Sec. 704(c) adjustments carryover to the transferee partner. Treas. Reg. §1.704-3(a)(7) provides:

> If a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the contributing partner transfers a portion of its partnership interest, the share of built-in gain or loss *proportionate to the interest transferred* must be allocated to the transferee partner. (Emphasis added).

It is contemplated that Sam will contribute appreciated property (share of Growing, Inc. stock) to the LLC, in exchange for preferred units, managing units and residual units. A short time thereafter, the donor (which could be a family limited partnership interest) will transfer its preferred units to a NIMCRUT.

Under the regulations, the portion of IRC Sec. 704(c) gain "proportionate to the interest transferred" must be allocated to the NIMCRUT as transferee of the preferred units. Neither the regulations, nor any other relevant authorities, have addressed in further detail the manner for determining the "proportionate" portion of IRC Sec. 704(c) gain.[159]

However, the regulations contemplate that the transferee will "step into the shoes" of the transferor with respect to the allocation of IRC Sec. 704(c) gain. Thus, a reasonable method for allocating IRC Sec. 704(c) gain to the transferee of preferred units would be to: (1) determine the share of IRC Sec. 704(c) gain that would be allocable to the preferred units on the one hand, and the management and residual units on the other, if the built-in gain property were sold immediately before the transfer and (2) allocate to the transferee-partner that portion of built-in

[159] The Department of Treasury recently acknowledged the lack of guidance in this area. *See* T.D. 8902, 65 Fed. Reg. 57,092, 57,094 (September 21, 2000) (preamble to Treas. Reg. §1.1(h)-1).

gain that is attributable to the ownership of preferred units. For example, assume the preferred units have a $700 liquidation preference in aggregate, and the contributed property has a zero basis and a $1,000 value. If the contributed property were sold for value, $700 of the built-in gain would be allocated to the preferred units and $300 to the retained units. The $700 of built-in gain attributable to the preferred units would carry over to the transferee of such units.[160] Thus, if the partnership sells appreciated assets, 1% of the precontribution gain would be allocated to the donor through the managing units, 70% to the NIMCRUT and 29% to the donor through the residual units (or to the transferee of such units).

b. The future taxable income of the LLC should be allocated to the Preferred Unitholders to the extent of the preferred return.

The proposed structure contemplates that 99% of the income will be allocated to the preferred units until such units have been allocated an amount equal to a preferred return.[161] After the preferred units have been allocated their preferred return, the 99% allocation will be made to the residual units. One percent of the company's income always will be allocated to the managing units. As discussed below, until 99% of the company's cumulative income at least equals the cumulative preferred return, no taxable income should be allocated to the residual units (other than any IRC Sec. 704(c) gain, as discussed above).

A partner's "distributive share" of income and losses is determined by the partnership agreement, as long as the allocations contained in the agreement have "substantial economic effect."[162] If the allocations in an agreement do not have substantial economic effect, then each partner's distributive share of the partnership's income and loss is determined in accordance with the partner's interest in the partnership, taking into account all the facts and circumstances.

Accordingly, as long as allocations of taxable income have "substantial economic effect" or are otherwise in accordance with the partners' interests in the partnership, the partnership agreement may provide for the manner of sharing taxable income. In such case, the division of taxable income contained in the partnership agreement will control for federal tax purposes.

The Treasury Regulations contain a two-part safe harbor for determining whether an allocation of income, gain, loss, or deduction has "substantial economic effect."[163] First, the allocation must have "economic effect." Second, the allocation must be "substantial."

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[160] Another reasonable method for allocating IRC Sec. 704(c) gain could be to allocate such gain based on the relative fair market values of the retained and transferred interests. This would result in more built-in gain being allocated to the NIMCRUT as the residual units would have a fair market value less than their liquidation value due to discounts.

[161] If the preferred return in unpaid, it may cumulate or compound annually. It is likely that the preferred payments would cumulate (not compound) as do the NIMCRUT payments. Thus, the actual rate of return on the preferred units will be less than their stated rate if the payments are made on redemption of the preferred units.

[162] *See*, IRC Sec. 704(b).

[163] *See*, Treas. Reg. §1.704-1(b)(2)(i).

In general, an allocation has "economic effect" if the partnership agreement provides: (1) for the determination and maintenance of capital accounts in accordance with technical rules contained in the regulations, (2) upon the liquidation of the partnership, liquidating distributions are required be made in accordance with the positive capital account balances of the partners and (3) if a partner has a negative capital account following the liquidation of his interest in the partnership, either such partner is unconditionally obligated to restore such amount, or else the agreement provides for a qualified income offset.[164]

In addition to the "economic effect" requirement, the allocation must also pass muster under the "substantiality" test in Treas. Reg. §1.704-1(b)(2)(iii). Under this test, an allocation is "substantial" if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Even if this general test is satisfied, however, the effect of an allocation will not be substantial if: (1) the after-tax economic consequences of at least one partner may (in present value terms) be enhanced and (2) there is a strong likelihood that the after-tax economic consequences of no partner will (in present value terms) be substantially diminished; in each case, compared to such consequences if the allocations were not contained in the partnership agreement.[165] The contemplated LLC agreement will be structured to provide for allocations that should satisfy the above requirements. The partners' Capital Accounts will be increased by the value of the property contributed to the LLC. The LLC agreement will provide that 99% of the taxable income would be allocated first to the preferred unitholders, until the cumulative taxable income equals the cumulative preferred return to which such holders are entitled. The remaining 1% will be allocated to the managing units. The agreement would require a corresponding increase in the capital accounts of the preferred unitholders and managing unitholders, in accordance with the regulations. After sufficient taxable income has been allocated to reach the preferred return, remaining taxable income from the 99% portion will be allocated to the holders of the residual units. When and if such allocations are made, the capital accounts of the residual unitholders would likewise be increased. Also in accordance with the regulations, upon liquidation of the LLC, each unitholder would be entitled to a distribution equal to the positive balance in its capital account.

Moreover, the LLC agreement will not allow or permit "special" allocations of items of income (for example, taxable income to a tax-exempt partner and tax-free income to a taxable partner), which could raise issues under the "substantiality" requirement. Instead, the income allocations will in each case be "bottom line" or "net" income.

Accordingly, the contemplated income allocations should have substantial economic effect. As a result, with the exception of income governed by IRC Sec. 704(c) discussed

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[164] *See,* Treas. Reg. §1.704-1(b)(2)(ii)(b) and Treas. Reg. §1.704-1(b)(2)(ii)(d).

[165] *See,* Treas. Reg. §1.701-1(b)(2)(iii)(a).

above,[166] no taxable income will properly be allocated to the residual unitholders until the NIMCRUT holding preferred units has been allocated its cumulative preferred return. Throughout the term of the LLC, the managing unitholders will receive a 1% allocation of income.

The partnership anti-abuse rules (sometimes, hereinafter "Anti-Abuse Rules") authorize the Service to recharacterize a partnership transaction only if (1) a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal income tax liability and (2) the transaction is inconsistent with the intent of Subchapter K.[167] The Internal Revenue Service has indicated that the Anti-Abuse Rules will affect a relatively small number of partnership transactions.[168]

According to the regulations, the intent of subchapter K is "to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax."[169] The regulations state that "implicit in the intent" are the requirements that (1) the partnership must be bona fide and each partnership transaction must be entered into for a substantial business purpose, (2) the form of each transaction must be respected under substance over form principles and (3) the tax consequences under subchapter K must accurately reflect the partners' economic agreement and clearly reflect income. *Id.*

If the Commissioner determines that a transaction yields tax results that are inconsistent with the intent of subchapter K, the following remedies are available: (1) the purported partnership should be disregarded and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners; (2) one or more of the purported partners of the partnership should not be treated as a partner; (3) the partnership's method of accounting must be adjusted to clearly reflect income; (4) the partnership's items of income, gain, loss, deduction, or credit should be reallocated; or (5) the claimed tax treatment should be otherwise adjusted or modified.[170]

Whether a partnership was formed or availed of with a principal purpose to reduce substantially the partners' federal tax liability inconsistent with the intent of subchapter K is determined based on all the facts and circumstances.[171] No single factor is conclusive. *Id.*

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[166] That is, if the partnership sells all or a portion of contributed stock which has a built-in gain, each partner would be allocated taxable income equal to its portion of such gain (as discussed *supra* Section XII.E.2.a), irrespective of whether the preferred return has been satisfied.

[167] *See,* Treas. Reg. §1.701-2(b).

[168] T.D. 8588, 1995-1 C.B. 109 (preamble to final regulations).

[169] *See,* Treas. Reg. §1.701-2(a).

[170] *See,* Treas. Reg. §1.701-2(b).

[171] *See,* Treas. Reg. §1.701-2(c).

It would be difficult for the IRS to successfully argue that the proposed transaction is inconsistent with the "intent of subchapter K." As discussed below, the Code and regulations specifically contemplate that a person may become a partner by means of a gift of a partnership interest, and that such person would receive income allocations consistent with the economics of their interests.

First, IRC Sec. 704(e) provides a safe-harbor that "a person shall be recognized as a partner" for income tax purposes "if he owns a capital interest in a partnership in which capital is a material income producing factor, *whether or not such interest was derived by purchase or gift from any other person*." (Emphasis added).[172] The determination of whether capital is a material income-producing factor depends on the facts and circumstances.[173] Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital, but not where the principal source of income consists of fees, commissions, or other compensation for personal services performed by the partnership's members. *Id*.

For example, the tax court has determined that capital was a "material income producing factor" in a partnership created to purchase a lottery ticket.[174] The contemplated partnership (or any of its partners) will provide material services to others in exchange for fees, but rather that the partnership will derive income from its investment assets. As a result, the contemplated partnership should be one in which capital is considered to be a material income producing factor.

Second, the Code specifically provides that donees of partnership interests are not only entitled, but required, to include in gross income their share of partnership income. IRC Sec. 704(e)(2) specifically provides that a donee of a partnership interest includes in its gross income its distributive share of partnership income as determined "under the partnership agreement" (with certain modifications which should not apply here).[175] Particularly in light of this specific statute, the IRS can hardly assert that it is inconsistent with the "intent of subchapter K" to provide income allocations to a donee of the preferred units.

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[172] Although IRC Sec. 704(e) is entitled "Family Partnerships", the application of such section is not limited to family contexts. *See Evans v. Commissioner*, 447 F.2d 547, 550-51 (7th Cir. 1971).

[173] *See*, Treas. Reg. §1.704-1(e)(1)(iv).

[174] *Estate of Winkler v. Commissioner*, T.C. Memo 1997-4.

[175] IRC Sec. 704(e)(2) provides that the donee's distributive share must take into account an allowance for reasonable compensation for services rendered by the donor (such services are not contemplated here). The donee's distributive share also cannot be attributable to "donated capital" in an amount that is proportionately greater than the donor's share of capital. The regulations do not expand on this requirement. It is possible the IRS could argue that the preferred units are entitled to a disproportionate share of income because the units (which represent 90% of the company's units) are entitled to 99% of the income allocations until the preferred return has been satisfied. However, this argument would ignore that preferred return effectively "caps" the income to which the preferred units are entitled. Thus, if the assets of the partnership provide a high enough return, the preferred units could ultimately share in less than 90% of the aggregate partnership income.

Moreover, an IRS complaint that the contemplated transaction reduces the donor's tax (in that the donor may qualify for a charitable deduction) would ignore that *all* charitable deductions have this effect. Thus, the IRS can hardly complain that a donor is taking advantage of the Congressionally provided charitable deduction provisions.[176]

In sum, the Anti-Abuse Rules all but allow the IRS to undertake an "I know it when I see it" analysis in determining whether a partnership transaction should be recast, meaning that any conclusion in this area cannot be made free from any doubt. However, the IRS should fail, rather than prevail, if it attempted to recast the proposed transactions under the anti-abuse rule contained in Treas. Reg. §1.701-2.

The IRS might assert that the preferred units more resemble debt than equity. If the preferred units are debt rather than equity, then the allocation of income would be affected and gain might be realized on the creation of the LLC. However, as discussed below, the preferred units should be properly characterized as equity, rather than debt.

Courts have defined debt as "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or the lack thereof."[177] Under the contemplated structure, the preferred units should be properly characterized as equity rather than debt. First, the preferred return accrues only if and to the extent the partnership otherwise has income; there is no *unconditional* obligation to pay a fixed sum (i.e., interest) irrespective of the income of the enterprise. If the appreciation of the partnership's assets is insufficient to provide for the preferred return, the preferred unitholder has no legal recourse. This is substantially different from the position of a typical lender, which would insist on interest repayments regardless of the debtor's profitability. While not binding on the IRS, the form of the transaction will be cast as equity, rather than debt. Next, the preferred unitholder will have the potential to share in the company's losses. Although losses first will be allocated to the residual unitholders, losses that exceed the capital accounts of the residual unitholders will be allocated to the preferred unitholders to the extent of their capital accounts. Consequently, the type of risk and reward of the preferred unitholder is not the type of risk and reward of a lender.

Moreover, the preferred units are not entitled to a sum certain "at a reasonably close fixed maturity date." The LLC is, however, subject to mandatory dissolution in 19½ years. The IRS could argue that this fixed liquidation date is in substance a maturity date, and that this "debt-like" feature requires treatment of the preferred units as debt rather than equity. However, while there is a specific date at which the preferred unitholders (along with other equity holders) will be entitled to payment, that date is quite distant. Compelling the dissolution of an entity as the sole means of establishing a maturity date is not a feature of "typical" debt. Thus, the mandatory dissolution event at best provides only weak support for debt characterization.

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[176] *See*, IRC Sec. 170.

[177] *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957).

Moreover, while the preferred units have a liquidation preference, the partnership will be required to satisfy that preference only out of available assets at the time of liquidation -- the preferred unitholder will have no right to sue to collect any deficiency. Viewed as a whole, the preferred units should be treated as equity, rather than debt, for tax purposes.

c. Sam will only have to pay federal income tax resulting from items of income and gains allocated to the NIMCRUT only upon receipt of distributions from the NIMCRUT, which only occur when the NIMCRUT recognizes trust accounting income.

The NIMCRUT's trust accounting provisions should provide that the NIMCRUT receive "trust accounting income" only when the NIMCRUT receives a distribution or receipt in cash or other property, except to the extent that such receipt otherwise would be treated as principal under state law and represents a return of some part or all of the investment's "accounting value." An investment's accounting value is, in the case of a contribution, its fair market value on the date of contribution, and in the case of a purchase of an investment, the consideration paid. Thus, the NIMCRUT will not be in receipt of trust accounting income until the trust actually receives possession of money or other property from the LLC; the NIMCRUT's right to receive either the cash value or the surrender value of its interest in the LLC does not create trust accounting income, nor does the LLC's allocation of its items of income, gain, loss, deduction, or credit to the NIMCRUT create trust accounting income. Moreover, including capital gain and partnership distributions of gains in accounting income increases the federal tax ultimately payable.

With respect to the allocation of pre-contribution gain between trust accounting income and corpus, the Service does not rely upon local law. Under no circumstances may the trust instrument of an income exception charitable remainder trust allocate pre-contribution gain to trust income.[178] The NIMCRUT's definition of accounting value specifically should exclude pre-contribution gain from trust income and should provide that the non-charitable beneficiary be entitled to distributions only to the extent the NIMCRUT has trust accounting income from the year.

d. The income tax deduction of $7,000,000 that Sam receives for the remainder value of the NIMCRUT can be used to offset the gain recognized by the residual units.

e. Assuming the sale proceeds in the NIMCRUT partnership earn 7.5% a year for 20 years with 2% being taxed as tax-free income and 5.5% being taxed as capital gains (with a 30% turnover) the technique produces powerful income tax and estate tax savings over a 20-year period in comparison to no further planning and a similar estate plan with no charitable gift.

[178] *See*, Treas. Reg. §1.664-3(a)(1)(i)(b)(4); T.D. 8791 (December 10, 1998).

Under these assumptions, the plan produces over $5,000,000 more for the family and around $43,000,000 for the family's charitable causes in present value dollars in comparison to doing the same LAIDGT estate plan without the NIMCURT partnership technique.

The primary reason the technique works so well is power of pre-tax compounding of delaying the taxation of the taxable income that is allocated to the NIMCRUT ("income tax opportunity cost" in the table below). On the estate planning side, besides the power of pre-tax compounding, the valuation discounts are greater because a hypothetical buyer is not going to pay for the amount that goes to charity and there are potential greater discounts with a two-tiered subsidiary partnership structure. *See* the table below and *infra* Schedule 16.

Table 12

	Charity (1)	Saint Family (2)	Consumption		Lifetime IRS Income Taxes		Tax Liability of Estate		Total (9)
			Direct Cost (3)	Opportunity Cost (4)	Direct Cost (5)	Opportunity Cost (6)	Embedded Capital Gains Tax Liability[1] (7)	Estate Taxes (@ 40%) (8)	
20-Year Future Values									
No Further Planning	$0	$213,531,608	$63,861,644	$66,600,089	$65,937,250	$108,772,669	$0	$118,474,405	$637,177,665
Hypothetical Technique #1[2]	$0	$301,956,854	$63,861,644	$66,600,089	$69,462,172	$108,772,669	$8,223,995	$18,300,241	$637,177,665
Hypothetical Technique #2[3]	$70,000,000	$310,919,013	$63,861,644	$66,600,089	$72,638,284	$34,867,342	$2,818,388	$15,472,904	$637,177,665
Present Values (Discounted at 2.5%)									
No Further Planning	$0	$130,312,136	$38,972,906	$40,644,099	$40,239,588	$66,380,799	$0	$72,301,487	$388,851,014
Hypothetical Technique #1[2]	$0	$184,275,494	$38,972,906	$40,644,099	$42,390,745	$66,380,799	$5,018,865	$11,168,106	$388,851,014
Hypothetical Technique #2[3]	$42,718,966	$189,744,839	$38,972,906	$40,644,099	$44,329,034	$21,278,526	$1,719,981	$9,442,664	$388,851,014

(1) Embedded capital gains tax liability of assets that pass to the family that are not subject to estate taxes. This capital gains tax is only paid when those assets are sold.
(2) Hypothetical Technique #1 - Leveraged Assets Gifted to GST Tax Exempt Grantor Trusts without Using a NIMCRUT Partnership
(3) Hypothetical Technique #2 - Leveraged Assets Gifted to GST Tax Exempt Grantor Trusts in Combination With Using a NIMCRUT Partnership

Assumptions:	
Total estimated rate of return over the next 20 years	7.50%
Rate of Return Taxed at Ordinary Rates	0.00%
Rate of Return Taxed at Ordinary Rates	2.00%
Rate of Return Taxed at Capital Gains Rates	5.50%
Turnover Rate (% of Capital Gains Recognized/Year)	30.00%
Long-Term Capital Gains and Health Care Tax Rate	23.80%
Ordinary Income and Health Care Tax Rate	43.40%
Annual Consumption from these Sources	$2,500,000

Assumptions (continued):		
NIMCRUT Partnership - Growth Interest Valuation Discount	40.0%	
Estate Planning Partnership - Valuation Discount	30.0%	
NIMCRUT Partnership-Preferred Interest	$70,000,000	
NIMCRUT Partnership-Total Preferred Coupon/Currently Paying %	11.104%	1.44%
IRS 7520 Rate	6.275%	
IRS Applicable Federal Rate (long-term)	0.000%	
CRUT Payout	0.000%	
Charitable Deduction	$7,001,400	
Tax Savings from Charitable Deduction ($7,001,400 @ 20.0%)	$1,400,280	

3. Considerations of the technique.

   a. Will the deferral of the receipt of trust accounting income distributable to the NIMCRUT's non-charitable beneficiary cause the NIMCRUT to fail to function exclusively as a charitable remainder trust?

In 1997, the Service announced it was studying specifically "whether a trust that will calculate the unitrust amount under IRC Sec. 664(d)(3) qualifies as an IRC Sec. 664 charitable

remainder trust when a *grantor*, a trustee, or a beneficiary can control the timing of the trust's receipt of trust income from a *partnership* or a deferred annuity contract to take advantage of the difference between trust income under IRC Sec. 643(b) and income for federal income tax purposes for the benefit of the unitrust recipient (emphasis added)."[179] Because this is an area of "extensive study," the Service refuses to issue advanced rulings or determination letters with respect to charitable trusts where a partnership is involved.[180] It has not completed its study, and the study is not on the Service's business plan.

The proposed transaction contemplates that the grantor will *not* control the timing of the trust's receipt of trust income by retaining control of the LLC–which is *not* the situation under specific study by the IRS.[181] The timing of the trust's receipt of income in this example is mandated by the terms of the preferred partnership interest.

The following reasons support an argument that the proposed NIMCRUT will operate exclusively for charitable purposes, even if the donor controls the timing of the preferred payments (again, which is *not* what is contemplated by this example). Stated differently, what follows is an academic argument that does not pertain to this example, because *the timing of the distribution is mandated*. However, if the following reasoning is sound, then clearly a mandated delay in distributing income will not cause the NIMCRUT to fail to function exclusively as a charitable remainder trust.

First, the actual or potential use of the income deferral technique should not violate public policy. Congress created qualified charitable remainder trusts to ensure that the amount received by a charitable organization at the end of the trust reflects the amount on which the donor's charitable deduction was based. Congress' purpose will not be thwarted by the NIMCRUT's actual or potential use of the income-deferral technique because it will in no way reduce the amount receivable by charity at the end of the term. Under a positive investment return scenario, the charitable remainder beneficiary is always guaranteed a remainder of at least the trust's initial value. The charitable remainder beneficiary receives the trust's initial value because of the requirement that pre-contribution gain be allocated to principal. If the trust's investment performs at a loss, the income interest gets nothing while the remainder interest gets what is left.[182] Even though the make-up payment requirement otherwise could indicate a larger distribution to the non-charitable beneficiary, the pre-contribution gain rule caps the distribution so that the initial value goes to charity. Thus, the charitable remainder beneficiary in most cases

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[179] Rev. Proc. 97-23 (April 28, 1997); Notice of Proposed Rulemaking, 62 FR 19072 (April 18, 1997).

[180] *Id*.; Rev. Proc. 2001-3 (January 2, 2001).

[181] Prior to their announcement in 1997, the Service, in PLR 9114025, did not question a taxpayer's retention of control over a partnership where the taxpayer had contributed limited partnership interests to a net-income charitable remainder trust.

[182] Under the laws of some states, a portion of capital proceeds from the sale of non-productive property may be allocated to accounting income. In those states, charity may see a reduction in the value of its interest below the initial value of the trust. Of course, in a straight charitable remainder trust, the trust's initial value always is subject to payment of the unitrust amount and would decline more than under the proposed scenario.

only can be benefited by use of the income deferral feature, because use of a straight unitrust most likely would require use of principal at some point to satisfy the unitrust amount.

Second, the grantor's "use" of the NIMCRUT's assets should be a "permitted use," as discussed in the following section. In Technical Advice Memorandum 9825001 (October 29, 1997),[183] the Service had the chance to apply its "primary use" theory to a charitable trust in which the trustee had purchased deferred annuity contracts. However, after holding that the deferral of income was a "permitted use" of trust assets so as to not be an act of self-dealing, the Service concluded that "the purchase of the deferred annuity contracts [did] not adversely affect [the trust's] qualification as a charitable remainder trust under IRC Sec. 664 and the current regulations thereunder." Implicit from this ruling is that if the grantor's use of trust assets is "permitted," then such use will not cause the trust to fail to function exclusively as a charitable remainder trust.

Third, the NIMCRUT will have a significant charitable component, unlike the charitable trust arrangements targeted by Notice 94-78, which used a non-charitable payout percentage of 80%. The proposed NIMCRUT's non-charitable payout percentage must be at least 5% and not greater than 50% of the net fair market value of the trust's assets, according to IRC Sec. 664(d)(2)(A), and, according to IRC Sec. 664(d)(2)(D) the present value of the remainder interest passing to charity must be at least 10%. Congress imposed these statutory limitations in the Taxpayer Relief Act of 1997 (P.L. 105-34, §1089), effective for transfers in trust after June 18, 1997. Accordingly, they represent a conscious determination that net income charitable remainder unitrusts with this level of charitable benefit deserve tax-free treatment.

Finally, there is no published authority prohibiting the creation of a charitable remainder trust that enhances value to both the individual and the charity by deferring the payment of income, despite the donor's retention of control, probably because income deferral is inherent in the concept of a NIMCRUT.

Thus, where the grantor retains no control over distributions from the LLC, as in this proposed transaction, by having the distributions fixed at a mandatory liquidation date, the NIMCRUT will not fail to function exclusively as a charitable remainder trust. Where the grantor retains control over distributions form the LLC, despite the uncertainty the IRS study of the issue has produced, control may result in the NIMCRUT still not failing the exclusivity test.

b. Will the use of the LLC to defer the receipt of trust accounting income distributable to Sam be deemed an act of self-dealing under IRC Sec. 4941 and the regulations thereunder?

IRC Sec. 4947(a)(2) provides that the NIMCRUT is subject to IRC Sec. 4941's excise tax on self-dealing as if the NIMCRUT were a private foundation. "Self-dealing" includes any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets

[183] See, Note 12.

of a private foundation.[184] Self-dealing may also include the purchase or sale of stock or other securities by a private foundation if done in an attempt to manipulate the price of the stock or securities to the benefit of the disqualified person.[185]

Disqualified persons with respect to a NIMCRUT include its creator, its substantial contributors, its trustees and their respective family members.[186] A partnership will only be deemed a disqualified person with respect to the NIMCRUT if one or more substantial contributors or trustees retain a 35% or greater profits interest in the partnership.

The Service views the prohibition against using foundation assets by disqualified persons extremely broadly, scrutinizing transactions between charitable remainder trusts and disqualified persons for even an indirect benefit to the donor. For any act of self-dealing, the rate of tax is equal to 5% of the amount involved with respect to the act for each year (or part thereof) that the act remains uncorrected.[187] The tax is assessed against any disqualified person who "participates" in the act of self-dealing. Under IRC Sec. 4941(a)(2), if the trustee knowingly participates in an act of self-dealing, a tax is imposed on the trustee equal to 2½% of the amount involved with respect to the act of self-dealing for each year (or part thereof) that the act goes uncorrected, to a maximum of $10,000 for any single act.[188]

In TAM 9825001, the Service examined self-dealing under two theories (as noted above, this TAM examined the purchase of a deferred annuity unitrust by a NIMCRUT). Under the first theory—whether the trustee's purchase of a deferred annuity naming the grantor and his wife (disqualified persons) as annuitants constituted an act of self-dealing—the Service found no act of self-dealing because the grantors received no *current* benefit because of the contingent nature of the annuities (similarly, under the facts of this example, there is no current benefit to the annuitants of the NIMCRUT). The second theory relied on the assertion that the trustee either acted in concert with the donor on an ongoing basis or manipulated the assets of the trust for the donor's personal benefit, by furthering his income, retirement and tax planning goals. (The facts of this example are much more favorable, there is no opportunity for collusion because the trustee and the donor have no opportunity to manipulate the preferred partnership interest contract.) The Service examined whether the entire transaction taken as a whole–the purchase of a deferred annuity naming the donor and his wife as the annuitant, the failure to make withdrawals from the annuity policies, and the intention to subsequently make unitrust payments to the donor under the "make-up" provision of the trust–could be construed as an act of self-dealing under IRC Sec. 4941(d)(1)(E) by virtue of the authority provided by §53.4941(d)-2)(f)(1) of the Regulations. In analyzing this theory, the Service's decision turned

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[184] *See*, IRC Sec. 4941(d)(1)(E).

[185] *See*, Treas. Reg. §53.4941(d)-2(f)(1).

[186] *See*, IRC Sec. 4946, 507(d)(2).

[187] *See*, IRC Sec. 4941(a)(1).

[188] *See*, IRC Sec. 4941(c)(2).

on whether the income deferral charitable remainder trust had an unreasonable detrimental effect on the charitable interest.

The Service ultimately concluded that the transaction did not constitute self-dealing. IRC Sec. 4947(a)(2) charitable remainder trusts are different from regular IRC 501(c)(3) private foundations because a disqualified person is entitled to receive income from the trust as provided in the trust instrument. The income interest is, in itself, a use of trust assets for the benefit of the disqualified person. Inherently, any investment decision regarding the trust assets that increases or decreases the amount of payout of this income interest is inherently a use for the benefit of the disqualified person. IRC Sec. 4947(a)(2)(A) specifically excludes from the self-dealing rules payments made by charitable remainder trusts to income beneficiaries. Thus the relevant question is whether the deferral of income is a "permitted use." According to the ruling, the presence of an unreasonable effect on the charitable remainder interest distinguishes a permissible use of trust assets from an impermissible use. The IRS noted that the facts did not clearly indicate that the disqualified person controlled, compelled or influenced the trustee's investment decisions so as to manipulate the trust's assets for the disqualified person's benefit.

The negative inference of this TAM is that in some rare situations, the Service may, perhaps, be willing to find self-dealing. In Exempt Organizations Continuing Professional Education Text for fiscal 1999 ("1999 CPE Text"), the Service addressed whether placing variable annuities and partnership interests in which the distribution could be manipulated inside of a charitable remainder trust could result in an act of self-dealing. In 1999 CPE Text, the IRS clarified their position reflected in the TAM by specifically outlining three tests, *all* of which the taxpayer must flunk to find self-dealing of this sort. The first two tests relate to the "manipulation" requirement based in Reg. §53.4941(d)-2(f)(1).

First, for the requisite "manipulation" to occur, a disqualified person or income beneficiary must control the trustee's investment decisions for a "specific personal purpose of the disqualified person or income beneficiary" by serving as trustee or by acting in concert with the trustee regarding the trustee's *investment decisions*. Accordingly, as long as the trustee of the NIMCRUT is not a disqualified person or income beneficiary, the IRS would not find this type of manipulation with respect to the proposed transaction. With respect to this test, the IRS discussion did not contemplate the ability of the grantor to "manipulate" the trust assets by retaining control over the trust's assets themselves, i.e., by retaining control over the partnership. However, the possibility remains that the Service would deem the grantor's retained control over the LLC to be a manipulation of the trust assets for the specific personal purpose of the disqualified person. Again, this suggests the cautious approach of relinquishing control of the LLC to someone other than the grantor or providing for a partnership interest in which the timing and amount of the distributions are mandatory.

Second, there must be specific evidence that the trust's assets and investments were manipulated to serve the grantor's personal advantage and current benefit beyond merely the receipt of the income provided by the trust instrument. Under the facts of this example, there is

no such manipulation. The grantor will receive no other current benefit from the NIMCRUT because no other property rights are created and transferred to the grantor for his current benefit.[189]

Finally, in determining whether the deferral is a permitted use, the Service will examine whether it causes an unreasonable effect on the charitable remainder interest. The unreasonable effect requires an evaluation of the income realized by the charitable interest as well as the appreciation in value of the charitable assets over the term of the trust. Because the Service does not second-guess the investment decisions of the trustee in this regard, the "unreasonable effect" means something more than just bad investment judgment. In the case of this example, the deferral of income is permitted because the charitable remainder interest is not unreasonably affected. The charitable remainder interest only can be advantaged, not disadvantaged, by deferral of the receipt of trust accounting income through investment in the FLP – hardly an unreasonable effect. As discussed above, the charitable remainder beneficiary is always guaranteed a remainder of at least the trust's initial value, unless, of course, the value of the trust's assets drop below the trust's initial value or local law rules on unproductive property apply.[190]

Because the 1999 CPE Text requires all three elements for self-dealing to exist, even if there existed grantor control over the timing of the distributions from the LLC, which accrue to the NIMCRUT, that control should not result in a self-dealing transaction under this analysis. As noted above, charity simply is not disadvantaged. However, the 1999 CPE Text is not binding on the IRS. Caution dictates, therefore, that the grantor, *as in the transaction described in this this example*, should not have the power to control the timing of the preferred distributions from the LLC, in order to remove any self-dealing concern.

c. This technique is not appropriate for investments that would be unrelated business taxable income investments.

F. Using the technique of contributing a preferred partnership interest in a family partnership to a CRAT in combination with the LAIDGT technique.

1. The technique.

Example 20: Jane Justright Contributes a Preferred Partnership Interest to a CRAT in Combination With the LAIDGT Technique in Order to Save Income and Transfer Taxes

Jane Justright, like Sam Saint in Example 19, is very wealthy. Jane, like Sam, has a $150,000,000 portfolio with $100,000,000 of that portfolio in Growing, Inc. stock, a publicly traded stock. Jane has no basis in her shares of Growing, Inc. stock. Jane would like to diversify

[189] *See*, TAM 9825001.

[190] While not binding on the Service and of no precedential value, a Technical Advice Memorandum is indication of how the Service would rule on a similar set of circumstances in the future.

out of that stock in a tax efficient manner. Jane likes the tax deferral and cash flow aspects of charitable remainder annuity trusts (CRATs). She desires steady cash flow and has deferred charitable intent - up to a point. She does like the potential windfall aspect of charitable remainder trusts: (i) she could die early; and/or (ii) the investments of the trust could out perform the IRS assumed earnings rate built into the actuarial tables. Jane thinks it is particularly unfair that she would not receive an income tax deduction for that windfall, if it occurs. Jane asks her attorney, Fay Fair, what she can do to ensure that she receives tax justice, if she creates a charitable remainder annuity trust. Jane also asks her attorney, Fay Fair, to assume she would like a little over 9% of her projected estate (before estate taxes) to go to her favorite charities with the remainder going to her family. Jane would also like to minimize her gift and estate taxes.

A CRAT makes distributions of a fixed dollar amount to one or more noncharitable beneficiaries for the beneficiary's lifetime or set term of years.[191] At the end of the term, the remaining trust properties must be paid to a charity or charities. Under current law, the payout rate to the individual annuitant must be at least 5% of the initial fair market value of the trust[192] and cannot exceed 50%.[193] Like other types of charitable remainder trusts, the value of the gift to charity must be at least 10%.[194]

The CRAT will pay the noncharitable beneficiary a constant amount whether the underlying value of the assets appreciates or depreciates. Thus, in a level or down market the charity is taking the "risk" and the client annuitant is protected.

The CRAT is easy to administer. When the trust is established, the amount that must be distributed annually for the entire term of the trust is set. Therefore, there is no need for the trustee to compute the fair market value of the assets annually which can be burdensome if the trust owns hard to value assets.

However, the distributions of a CRAT to the individual annuitant are taxed unfavorably. Under the tiered income rules, the income beneficiary has her distribution characterized for income tax purposes by reference to the historic income of the trust since its creation under IRC Sec. 664(b).[195] A distribution is first taxed as ordinary income to the extent of the trust's current and past undistributed ordinary income, the next tier is taxed as capital gains income to the extent of the trust's current and past capital gains income, the next tier is taxed as tax-exempt income to the extent of the trust's current and past tax exempt income, and the final tier (if any) is considered a return of capital.

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[191] Treas. Reg. §1.664-2(a)(1).

[192] Treas. Reg. §1.664-2(a).

[193] IRC Sec. 664(d)(1)(A) as amended by the Taxpayer Relief Act of 1997, H.R. 2014, 8/5/97.

[194] IRC Sec. 664(d)(1)(D).

[195] All references to the IRC or to the "Code" are to the Internal Revenue Code of 1986, as amended.

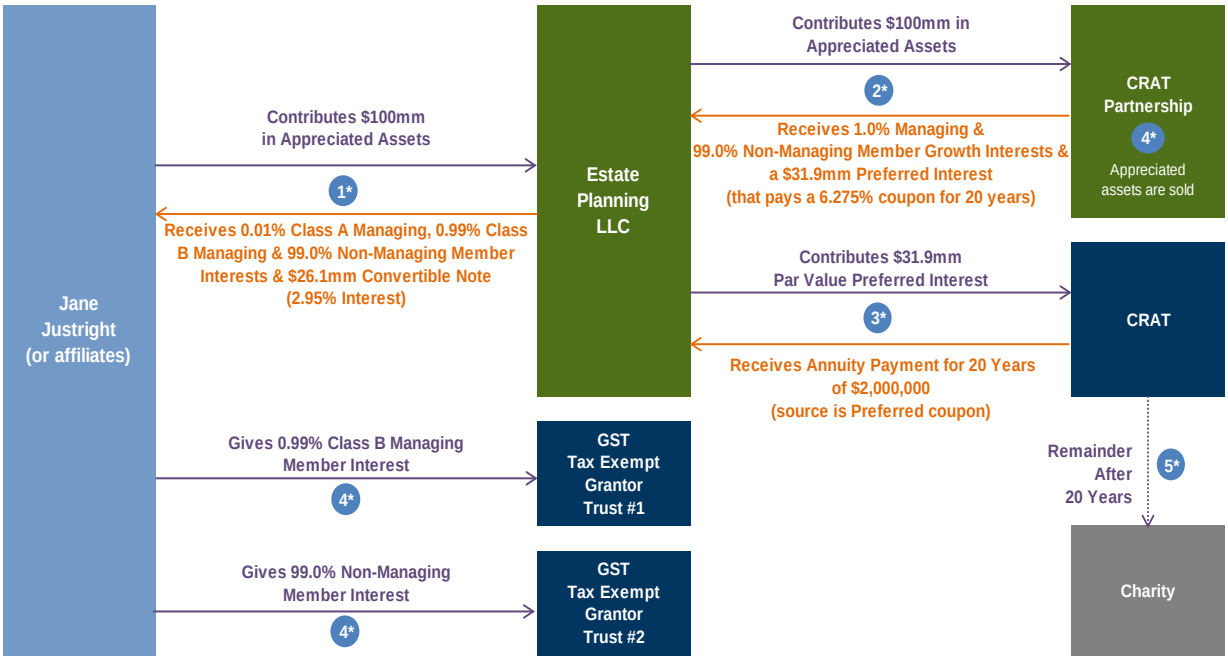
A CRAT cannot receive additional assets following the initial contribution.

The value of the distribution to the noncharitable beneficiary is not augmented by the appreciation of the underlying value of the trust assets.

A CRAT cannot own any unrelated business income investments.

A CRAT is non-amendable and irrevocable.

Fay may suggest that Jane and her family create a partnership ("CRAT Partnership" in the illustration below). Jane could contribute her highly appreciated security (shares of Growing, Inc. stock) to the CRAT Partnership. Assume approximately one-third of the partnership interest that Jane receives is a preferred partnership interest that pays an annual fair market rate of return (*e.g.*, 6.275% per year). Jane could contribute her interest in the CRAT and her respective CRAT Partnership interests to an Estate Planning LLC. After the contribution is made to the CRAT, the CRAT Partnership could sell the appreciated securities. Jane could retain a convertible note from the Estate Planning LLC and transfer the LLC member interests to GST trusts (i.e., she could use the LAIDGT technique described *supra* Section IV). *See* the illustration to Example 20 below:



*Transactions need to be separate, distinct and independent.

2. Advantages of the technique.

a. There will be no immediate capital gains taxes on that proportionate part of the partnership that is owned by the CRAT when the Growing, Inc. stock is sold.

See the discussion *supra* Section XII.E.2.a.

b. Since the preferred coupon is being paid currently, it will probably have a lower rate of return than the deferred preferred coupon used in the preferred interest with a NIMCRUT .

The preferred coupon can provide the cash flow that donor's desires.

c. A donor's fear of a charitable windfall for the charity with the use of the CRAT technique is at least partially addressed by the use of preferred partnership interest.

If the partnership's investments out perform the IRS actuarial assumptions, that performance will go to the owners of the growth interests of the partnership, not the owners of the preferred partnership interests.

d. This technique also provides current cash flow to those client's and/or families who need the current cash flow.

e. The income tax deduction of the remainder value of the CRAT can be used to offset the gain recognized by the non-preferred owners.

f. The synergies of this technique can produce powerful income tax benefits and estate planning benefits as the table below illustrates (*see infra* Schedule 17):

Table 13

	Charity (1)	Justright Family (2)	Consumption		Lifetime IRS Income Taxes		Tax Liability of the Estate		Total (9)
			Direct Cost (3)	Opportunity Cost (4)	Direct Cost (5)	Opportunity Cost (6)	Embedded Capital Gains Tax Liability[1] (7)	Estate Taxes (@ 40%) (8)	
20-Year Future Values									
No Further Planning	$0	$213,531,608	$63,861,644	$66,600,089	$65,937,250	$108,772,669	$0	$118,474,405	$637,177,665
Hypothetical Technique #1[2]	$0	$302,196,270	$63,861,644	$66,600,089	$69,548,356	$108,772,669	$8,425,071	$17,773,567	$637,177,665
Hypothetical Technique #2[3]	$31,872,510	$317,986,205	$63,861,644	$66,600,089	$64,411,446	$86,727,806	$5,717,966	$0	$637,177,665
Present Values (Discounted at 2.5%)									
No Further Planning	$0	$130,312,136	$38,972,906	$40,644,099	$40,239,588	$66,380,799	$0	$72,301,487	$388,851,014
Hypothetical Technique #1[2]	$0	$184,421,602	$38,972,906	$40,644,099	$42,443,341	$66,380,799	$5,141,576	$10,846,691	$388,851,014
Hypothetical Technique #2[3]	$19,450,867	$194,057,741	$38,972,906	$40,644,099	$39,308,434	$52,927,460	$3,489,508	$0	$388,851,014

(1) Embedded capital gains tax liability of assets that pass to the family that are not subject to estate taxes. This capital gains tax is only paid when those assets are sold.
(2) Hypothetical Technique #1 - Leveraged Assets Gifted to GST Tax Exempt Grantor Trusts without Using a CRAT Partnership
(3) Hypothetical Technique #2 - Leveraged Assets Gifted to GST Tax Exempt Grantor Trusts by Using a CRAT Partnership

Assumptions:	
Total Estimated Rate of Return Over the Next 20 Years	7.50%
Rate of Return Taxed at Ordinary Rates	0.00%
Rate of Return Taxed at Ordinary Rates	2.00%
Rate of Return Taxed at Capital Gains Rates	5.50%
Turnover Rate (% of Capital Gains Recognized/Year)	30.00%
Long-Term Capital Gains and Health Care Tax Rate	23.80%
Ordinary Income and Health Care Tax Rate	43.40%
Annual Consumption from these Sources	$2,500,000

Assumptions (continued):	
CRAT Partnership - Growth Interest Valuation Discount	40.00%
Estate Planning Partnership - Valuation Discount	30.00%
CRAT Partnership - Preferred Interest	$31,872,510
CRAT Partnership - Preferred Coupon	6.28%
IRS 7520 Rate	3.40%
IRS Applicable Federal Rate (long-term)	2.95%
CRUT Payout	6.28%
Charitable Deduction	$3,292,343
Tax Savings from Charitable Deduction ($3,292,343 @ 20.0%)	$658,469

Under these assumptions, the plan produces, in present value dollars, around $10,000,000 more for the family and around $19,500,000 more for the family's charitable causes in comparison to doing the same LAIDGT estate plan without the CRAT partnership technique.

3. Considerations of the technique.

a. This technique does not defer the taxation of cash flow, if the client does not need that cash flow. Stated differently, this technique has the potential of distributing more cash flow than a client needs and, thus, accelerates tax consequences unnecessarily.

b. This technique is not appropriate for that part of a client's portfolio, which the client wishes to put into ordinary income investments (because of the disadvantages inherent in the tiered income rules) or in unrelated business income investments.

XIII. POST-MORTEM STRATEGIES THAT LOWER THE NET TOTAL INCOME TAX AND TRANSFER TAX.

A taxpayer will receive a step-up in basis of his low basis assets that are subject to estate taxes. While beneficial, the taxpayer's family still has to pay estate taxes. What follows are four techniques that benefit the family and eliminate the estate tax even when substantial low basis assets are subject to the estate tax.

A. Use of a Leveraged Buy-Out of a Testamentary Charitable Lead Annuity Trust ("CLAT").

1. The technique.

a. Introduction.

The "conventional wisdom" this author sometimes hears on this subject is as follows: "one can never self-deal, even on a fair basis, with a foundation or a CLAT;" "the problem with testamentary gifts to charity is that the decedent's family always ends up with substantially less;" or "the problem with testamentary CLATs is that the decedent's family has to wait a long time to have access to the decedent's assets." This "conventional wisdom," under the circumstances discussed below, is incorrect.

Assume a client, at his death, wishes for part of his estate to go to his family and the rest to his favorite charitable causes. One technique that is generally considered under those circumstances is the CLAT.

Example 21: Use of a Testamentary CLAT in Conjunction With a Leveraged Redemption of a Partnership Interest Held by a Decedent

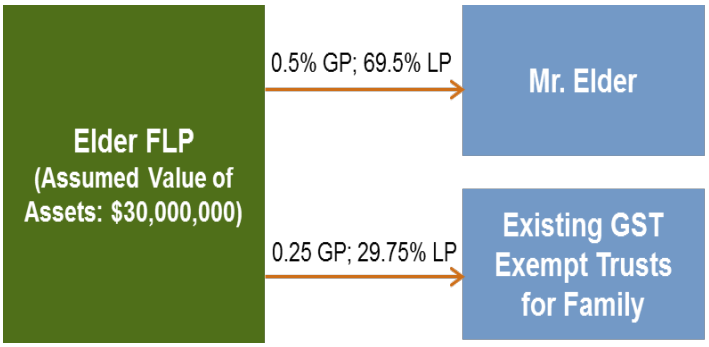
Ed Elder and his family create a FLP. Ed Elder owns 70% of the partnership interests after contributing $30,000,000 in assets to the FLP and doing some lifetime gifting to a

generation-skipping trust. Ed does not have any estate tax exemption remaining. The estate tax rate is 40%. However, Ed dies unexpectedly before he has had a chance to make additional transfers of limited partnership interests to trusts for the benefit of his family. It is assumed a valuation discount of 40% of the transferred partnership interests is appropriate. What would be the effect on Ed's estate plan, under those circumstances, if his will bequeaths an upfront dollar gift to trusts for the benefit of his family and the rest to a "zeroed out" testamentary charitable lead annuity trust (CLAT)?

Assume Ed's will provided that the first $3 million of his estate goes to trusts for the benefit of his family and the rest to a 100% "zeroed out" CLAT that is to last for 20 years. Assume that the FLP buys out the charitable lead annuity trust interest in a probate trust proceeding that fits the requirements of the regulations under IRC Sec. 4941.[196] *Assume the partnership interest is redeemed with an interest only note (which pays interest equal to the dollar amount that is owed for the annuity payments to the charitable beneficiaries of the CLAT) with the principal of the note being paid in the 20th year. Finally, it is assumed that the IRC Sec. 7520 rate is 1.0% at the time of Ed's death.*

This technique is illustrated below:

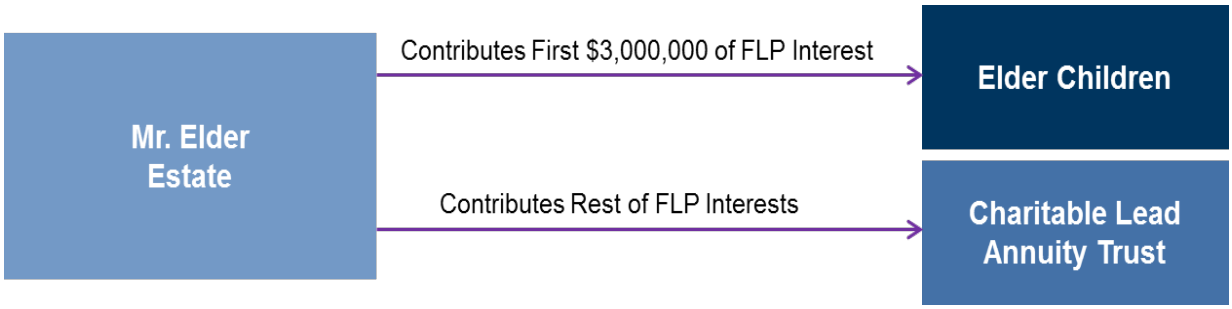
During Ed's lifetime he creates a FLP with his family.



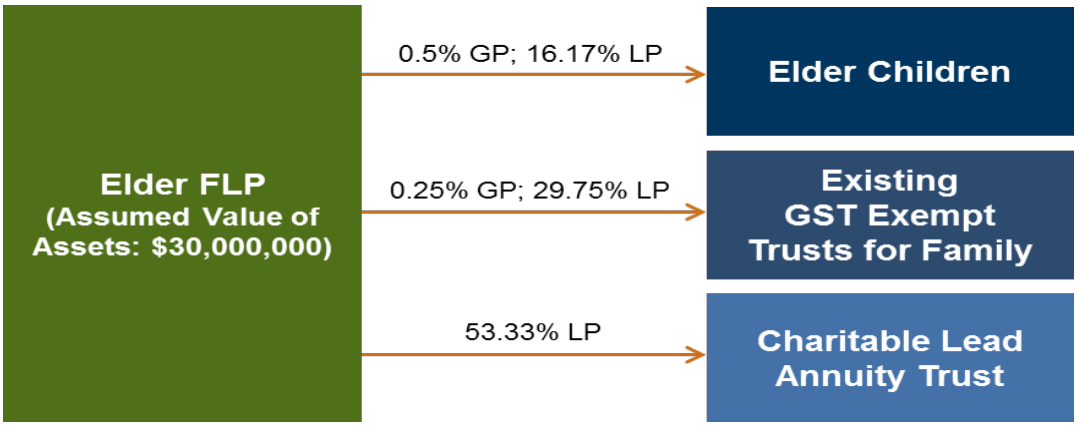
Elder, LP Partner	Ownership (%)
Mr. Elder	0.5% GP; 69.5% LP
Existing GST Exempt Trusts for Family	0.25% GP; 29.75% LP

After Ed's death his will conveys his FLP interest as follows:

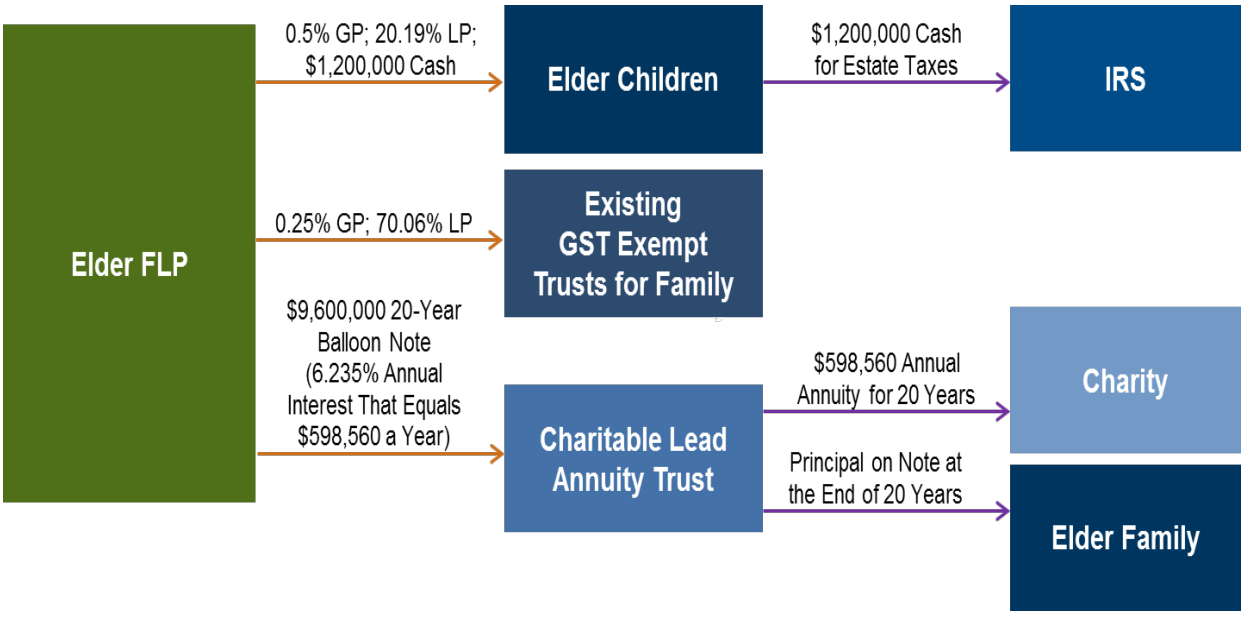
[196] *See* PLR 200207029 (Nov. 21, 2002); PLR 200124029 (Mar. 22, 2001); PLR 20024052 (Nov. 2, 2001); *see also* Daniels & Leibell, "Planning for the Closely Held Business Owner: The Charitable Options," 40th Philip E. Heckerling Institute on Estate Planning, Chapter 12 (2006).



The percentage ownership of Elder FLP before any redemption pursuant to a probate court hearing is as follows:



After a probate hearing the children's interest is partially redeemed and the CLAT's interest is totally redeemed as follows:



b. What is a CLAT?

See supra Section XII.C.

c. What is a leveraged buyout testamentary CLAT?

During probate administration, one of the exceptions to the self-dealing rules, with respect to foundations and CLATs, is that a self-dealing transaction may occur if certain restrictions are met. For instance, if a partnership interest that is to pass to a CLAT is redeemed for a note that may be a permissible transaction.[197] One requirement is that the note has a fair market value that is at least equal to or greater than the fair market value of the existing redeemed partnership interest. Another requirement is that the note must be just as liquid, if not more liquid, than the existing partnership interest. Assuming the appropriate probate court approves the leverage buyout, the note could be structured to be an interest only negotiable note, with the interest rate being higher than the existing AFR rate (e.g. 5.42% in comparison to a long term AFR of 2.18%), with a balloon payment at the end of 20 years (assuming a 20 year testamentary CLAT).

2. Income tax and basis enhancing advantages of the technique.

a. There is a partial step-up in basis in the decedent's partnership interest that is bequeathed to a zeroed-out CLAT.

If a discounted partnership interest is bequeathed to a CLAT the assets of the partnership may receive a partial step-up in basis if an IRC Sec. 754 election is made. The step-up in the partnership assets will need to take into account the valuation discounts that will exist with the bequeathed partnership interests.

b. There will be income tax deductions for the interest paid to the CLAT, assuming the investment income of the partnership is greater than the interest expense.

3. Transfer Tax Advantages of the Technique.

a. No estate taxes have to be paid with a gift to a properly structured and implemented zeroed-out CLAT.

Since the principal of the balloon note, when it is due, is coming back to the family as the remaindermen of the CLAT, the only out of pocket cost to the decedent's family are the interest payments on the note. However, those interest payments are heavily subsidized. The decedent's family will receive: (i) an upfront estate tax charitable deduction for the present value of those

[197] *See* Treas. Reg. §53.4941(d)-2; *see also* Matthew J. Madsen, "Funding a CLAT with a Note," 30 Est. Plan 495, 2003 WL 22213736 (2005).

interest payments using a low present value discount factor (the then IRC Sec. 7520 rate); and (ii) an income tax deduction for each interest payment as it occurs.

b. If the decedent bequeaths a dollar gift to his family and the rest of his estate to a zeroed-out CLAT, his will acts like a defined value allocation clause.

Even if all of the assets of the estate are hard to value, the only estate taxes to be paid are on the dollar gifts to the family. Any increase in the value of the estate by the IRS will result in no increase in estate taxes and a future decrease in income tax revenues.

c. Significant improvement in the after tax net worth for both the family of the decedent and the decedent's favorite charitable causes will accrue because of this technique.

What would the results be for Ed's family and his charitable beneficiaries under those circumstances in comparison to a gift only to his family (with the IRS allowing a full discount for the partnership interests)? What would be the comparison if the IRS did not allow any discount for the gift to the family? What difference would it make in comparison of the various alternatives if the family earned 3% before taxes, 7.5% before taxes and 10% before taxes during the 20-year period after Ed's death? What difference would it make if instead of bequeathing $3 million to Ed's family, Ed had bequeathed $10 million to his family with the rest to the zeroed out CLAT? The results of those comparisons are summarized below (*see* Schedule 18 attached).

Table 14a
Summary of Results For $30 Million of Assets Growing at 3% Per Year (Pre Tax) – No Further Planning vs. 20 Year Testamentary CLAT Technique; 20 Year Future Values; Post-Death Scenarios (assuming Mr. Elder dies in year 1)

Technique	Elder Children	Elder GST Exempt Trust	Charity	IRS Taxes on Investment Income	IRS Investment Opportunity Cost	IRS Estate Tax	Total
No Further Planning - No Charitable Gift No Discount Allowed	$18,333,733	$15,073,672	$0	$5,253,849	$7,522,083	$8,000,000	$54,183,337
No Further Planning - No Charitable Gift Discount Allowed	$23,059,178	$15,073,672	$0	$5,956,415	$5,294,072	$4,800,000	$54,183,337
Hypothetical Technique - CLAT Redemption Discount Allowed - $3mm to Family	$16,818,670	$17,096,849	$16,083,531	$1,747,005	$1,237,281	$1,200,000	$54,183,337
Hypothetical Technique - CLAT Redemption Discount Allowed - $10mm to Family	$22,778,999	$14,337,710	$4,355,956	$4,501,200	$4,209,472	$4,000,000	$54,183,337

Table 14b
Summary of Results For $30 Million of Assets Growing at 7.50% Per Year (Pre Tax) – No Further Planning vs. 20 Year Testamentary CLAT Technique; 20 Year Future Values; Post-Death Scenarios (assuming Mr. Elder dies in year 1)

Technique	Elder Children	Elder GST Exempt Trust	Charity	IRS Taxes on Investment Income	IRS Investment Opportunity Cost	IRS Estate Tax	Total
No Further Planning - No Discount Allowed	$33,734,275	$27,222,640	$0	$19,049,212	$39,429,406	$8,000,000	$127,435,533
No Further Planning - Discount Allowed	$42,018,677	$27,222,640	$0	$21,535,391	$31,858,825	$4,800,000	$127,435,533
Hypothetical Technique - CLAT Redemption Discount Allowed - $3mm to Family	$26,774,735	$40,677,004	$25,920,450	$16,803,779	$16,059,565	$1,200,000	$127,435,533
Hypothetical Technique - CLAT Redemption Discount Allowed - $10mm to Family	$41,011,327	$27,292,259	$7,020,122	$20,117,950	$27,993,875	$4,000,000	$127,435,533

Table 14c
Summary of Results For $30 Million of Assets Growing at 10% Per Year (Pre Tax) – No Further Planning vs. 20 Year Testamentary CLAT Technique; 20 Year Future Values; Post-Death Scenarios (assuming Mr. Elder dies in year 1)

Technique	Elder Children	Elder GST Exempt Trust	Charity	IRS Taxes on Investment Income	IRS Investment Opportunity Cost	IRS Estate Tax	Total
No Further Planning - No Discount Allowed	$49,533,164	$39,520,097	$0	$29,956,665	$74,815,071	$8,000,000	$201,824,998
No Further Planning - Discount Allowed	$61,335,976	$39,520,097	$0	$33,800,051	$62,368,873	$4,800,000	$201,824,998
Hypothetical Technique - CLAT Redemption Discount Allowed - $3mm to Family	$36,556,659	$63,844,719	$34,282,524	$29,612,351	$36,328,746	$1,200,000	$201,824,998
Hypothetical Technique - CLAT Redemption Discount Allowed - $10mm to Family	$59,592,669	$40,494,791	$9,284,850	$32,455,697	$55,996,990	$4,000,000	$201,824,998

The primary reason the leveraged buy out CLAT technique has a good result for both the client's family and the client's favorite charities, is that, in effect, the client's family is getting two different tax deductions for the interest payments that they are making on the note. There is an estate tax deduction (i.e., the zeroed out CLAT annuity payments) and the family owners of the FLP are also receiving an income tax deduction on the interest payments (assuming there is enough partnership investment income to offset the interest expense). The combined effect of those two different tax deductions is to heavily subsidize the interest payments. Another reason the technique has a good result for the family is that they are not out-of-pocket cash to pay the principal of the note to a third party. From Ed Elder's children's perspective, the principal of the note is, in effect, paid to themselves, since they are the remainderman of the CLAT.

d. The family does not have to wait 20 years to access the investments, if the investments are successful.

One of the downsides of a long term testamentary CLAT (e.g. 20 year term CLAT) is that the remainder beneficiaries have to wait until the CLAT terminates to access the capital of the CLAT. With the leveraged buy-out testamentary CLAT, assuming a conservative sinking fund is set aside to pay future interest payments, the family owners of the partnership may access the rest of the funds of the partnership and, of course, invest the rest of the funds of the partnership.

4. Considerations of the technique.

a. Need to get probate court approval.

As noted, above the appropriate probate court will need to find that the note has a fair market value equal to or greater than the partnership interest that is being redeemed and the note needs to be more liquid than the redeemed limited partnership interest. The second requirement should be relatively easy to satisfy if the note is negotiable and the first requirement should also be easy to satisfy because subject interest rate should be equal to or greater than the true "fair market value" interest rate.

b. Leverage could work against the family unless a carefully constructed partnership sinking fund is utilized to pay future interest payments.

If the managers of the partnership do not carve off part of the partnership assets to develop a carefully constructed sinking fund that is conservative in order to assure that future interest payments that are paid to the charitable beneficiary of the CLAT, the assets of the partnership, and the assets available to the family, could decrease.

B. The Use of the Deceased Spouse's Unused Exemption Amount ("DSUE Amount") to Take Advantage of the Grantor Trust Rules to Save Future Estate Taxes and to Simulate the Tax and Creditor Protection Advantage That a Significant Credit Shelter Trust Would Give a Surviving Spouse.

1. The technique.

Portability permits the estate of the first spouse to die of a married couple to elect to transfer the DSUE amount to the surviving spouse who could use it for making gifts and sales to a grantor trust.[198] *See* IRC Sec. 2010. A surviving spouse's gift of non-managing interests in a family entity to a grantor trust using the DSUE amount, and sales by the surviving spouse of non-managing interests in a family entity to the grantor trust, will generally result in a much better result than traditional credit shelter trust planning because of the greater use of grantor trust planning. Consider the following example.

Example 22: Use of the DSUE amount to Create a Larger Grantor Trust in Lieu of the Use of a Credit Shelter Trust

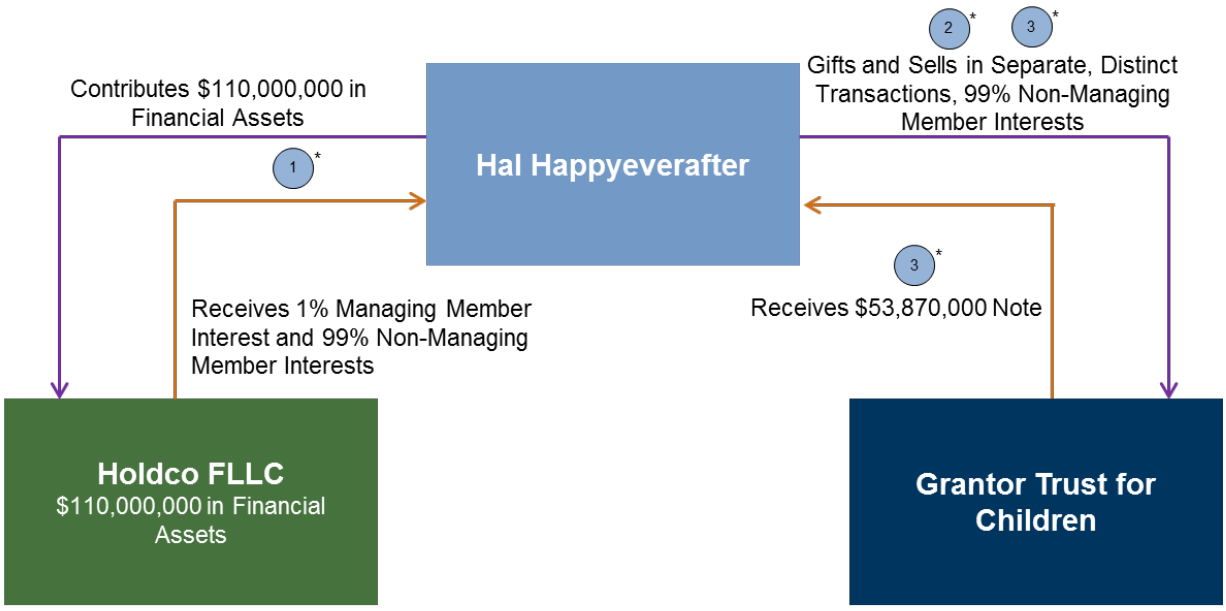
Harriett Happyeverafter is married to Hal Happyeverafter. Harriett has been very successful and has built a $110,000,000 estate during her 50-year marriage. Her goals, if Hal survives her, are to provide for Hal. Upon Hal's death, Harriett wishes for her remaining estate to pass to their children. Harriett has never engaged in lifetime gifting strategies for a variety of reasons, one of which is that she has very low basis assets. Harriett likes the protection, tax benefits and simplicity of the credit shelter trust that could be created on her death. However, Harriett is concerned that the credit shelter trust only protects about one-tenth of her net worth from future estate taxes and creditors. Harriett is intrigued about the possibility of Hal using her DSUE amount, and other techniques, to enhance the benefits of grantor trust planning.

Harriett tells her attorney, Ima Mathgeek, that Hal will need approximately $1,000,000 a year for his consumption needs. Harriett would like Hal to control her investments after her death. Harriett asks Ima to make the following assumptions: her assets will annually earn 7.4% before income taxes with 0.6% of the return being taxed at ordinary rates, 2.4% of the return being tax-free and 4.4% of the return being taxed at long-term capital gains rates (with a 30% turnover rate). Harriett asks Ima to assume Hal will live for 10 years after her death. Harriett asks Ima to design a structure that Hal could use with the DSUE amount to enhance the benefits of grantor trust planning.

Ima suggests that after Harriett's death Hal could create a single member FLLC with managing and non-managing interests. Hal in independent steps could gift and sell the non-managing interests to a grantor trust in which their children are beneficiaries. The original gift to the grantor trust will use the DSUE amount. Ima assumes a 30% valuation discount for

[198] *See*, Thomas W. Abendroth "Portability: Now Available in Generic Form" Chapter 2, 48th Annual Heckerling Institute on Estate Planning (June, 2014).

the non-managing interests will be allowed. The structure, after completion, is illustrated as follows:



* These transactions need to be separate, distinct and independent.

2. Income tax and basis enhancing advantages of the technique.

a. There is a step-up in basis of the deceased spouse's assets at her death.

This technique is particularly advantageous for a taxpayer who has a low basis or negative basis asset. There will be a step-up in basis that is equal to the fair market value of the assets.

b. There is an opportunity through using borrowing strategies from third party lenders for the surviving spouse to increase the basis of the family's assets during his lifetime.

The surviving spouse could substitute cash for any assets owned by Holdco that appreciate during his lifetime. *See supra* Section VIII. It is much more difficult to use borrowing strategies to enhance the basis of trust assets in a complex trust.

c. All of the income tax and basis enhancing advantages of creating a grantor trust and selling assets to a grantor trust are present with this technique.

See discussion of the SIDGT technique *supra* Section III.B.

3. Transfer tax advantages of the technique.

a. Significantly more assets may be passed to the next generation by using this technique than using the exemption to fund a credit shelter trust that is taxed as a complex trust.

Using the synergies of a discounted sale of non-member interests to a grantor trust and paying the note with pre-income tax dollars, is a much more powerful planning technique than a transfer to a complex trust that pays its own income taxes. This technique, once again, demonstrates the synergistic power of discounted sales to a grantor trust.

Ima wishes to compare using a traditional credit shelter trust by the first spouse to die with DSUE planning. The context of the comparison is the use of a discounted entity by the surviving spouse with a sale by the surviving spouse of non-managing member units to a grantor trust using the surviving spouse's available unified credit. Under the above assumptions, an additional $2,328,937 will be saved on the death of the surviving spouse, if that death occurs 10 years later. *See* the table below and attached Schedule 19.

Table 15

	Beneficiaries		Consumption		IRS Income Tax			IRS Estate Taxes at 40%	Total
	Happyeverafter Children (1)	Happyeverafter Children & Grandchildren (2)	Direct Cost (3)	Investment Opportunity Cost (4)	Direct Cost (5)	Investment Opportunity Costs (6)	Embedded Capital Gains Tax Liability (7)	(8)	(9)
10-Year Future Values									
Traditional Credit Shelter Planning: first to die spouse creates a credit shelter trust with her unified credit and balance of estate goes to a marital deduction trust	$84,901,072	$34,357,075	$22,406,764	$8,689,346	$12,693,504	$4,550,782	$414,058	$56,600,715	$224,613,316
	$119,258,147		$31,096,110		$17,658,344				
Traditional Credit Shelter Planning: First to die spouse creates a credit shelter trust with her unified credit; surviving spouse gifts and sells LLC interests to a new GST tax exempt grantor trust	$19,537,175	$138,767,406	$22,406,764	$8,689,346	$14,060,949	$4,550,782	$3,576,111	$13,024,783	$224,613,316
	$158,304,580		$31,096,110		$22,187,842				
Hypothetical Technique: First spouse to die bequests estate to surviving spouse; surviving spouse gifts his lifetime gift and the DSUE amounts to a grantor trust; Hal sells the remaining non-managing member interests to the grantor trust	$157,853,517	$2,780,000	$22,406,764	$8,689,346	$14,060,949	$4,550,782	$3,576,111	$10,695,846	$224,613,316
	$160,633,517		$31,096,110		$22,187,842				

b. Significantly more assets may receive protection from creditors by using sales to grantor trusts with the use of the DSUE Amount then using the exemption to fund a credit shelter trust.

See the above analysis and Schedule 19.

c. The surviving spouse's rights with respect to assets owned by the grantor trust, and cash flows produced by those assets, are pursuant to a flexible contract, rather than discretionary distributions by a trustee who is subject to fiduciary considerations.

There are certain advantages from the surviving spouse's point of view, and the family's point of view, in having the trust's obligations to the surviving spouse being contractual, instead of being under a discretionary standard that is subject to the fiduciary constraints of trust law and the trust document. In comparison to changing a trust document, changing a contract, if circumstances change, is relatively easy (assuming all parties to the contract agree). For instance, in this example, after a few years after the note has been reduced, it may be in Hal's best interest, and the trust's best interest, to convert part, or all, of the note to a private annuity. If the trustee and Hal agree to the change it may be changed without court involvement. A similar profound change in a trust document may require court involvement and the appointment of representatives for minor beneficiaries and unborn beneficiaries.

4. Considerations of the technique.

a. The surviving spouse may not transfer the DSUE amount in the manner that the deceased spouse anticipated.

This probably is not a technique that a taxpayer should use if there is any doubt that her spouse will not use the DSUE amount as anticipated. For instance, this may not be a very good technique in second marriage situations in which there exist blended families.

b. If the surviving spouse has creditor issues at the time of the first spouse's death, creating a family trust with the deceased spouse's unified credit will provide better protection from those creditors.

Generally, with respect to existing creditors of a surviving spouse, a third party created trust had a much better chance of protection than a trust created by the surviving spouse.

c. This technique has the same considerations as the creation of a grantor trust and a sale to a grantor trust.

See discussion *supra* Section III.C.

d. The GST tax exemption is not portable.

A credit shelter trust may be designed to be a dynasty trust. The grantor trust that is created by using the deceased spouses DSUE amount may not be generation skipping tax protected. The surviving spouse could use his own exemption to create a generation skipping trust that is also a grantor trust and save the DSUE amount to protect his estate on his death from estate taxes. The surviving spouse could also use his own exemption to create a generation-skipping trust that is also a grantor trust, use the DSUE amount to create a grantor trust for the first generation, with the first generation trust using low interest loans to the generation-skipping trust to maximize the generation-skipping benefits.

e. It may be more advantageous to convert a traditional credit shelter trust, with its attendant creditor protection and GST advantages, to a Section 678 grantor trust by using the QSST or the BDOT technique.

See discussion of this technique *infra* Sections IX.B, IX.C, XIII.C and XIII.D,.

f. It may be more advantageous for the decedent to have created the grantor trust during her lifetime and use her exemption to create the grantor trust for the benefit of the spouse before death.

However, unless there is careful management of the grantor trust during the grantor's lifetime, significant capital gains cost could accrue in comparison to creating the grantor trust after the grantor's death.

g. Like all leverage techniques, if the underlying assets stay flat or decline there is not any advantage to the technique and to the extent a gift tax exemption is used, the technique operates at a disadvantage.

C. Using the Synergies of a Credit Shelter Trust Becoming a QSST, a Surviving Spouse Creating a FLP and a Surviving Spouse Giving and Selling Interests in the FLP to a New Grantor Trust.

1. The technique.

A deceased spouse bequeaths her entire estate under a formula credit shelter plan. An amount equal to her remaining unified credit, assumed to be $11,180,000, passes to a credit shelter trust that pays all of its income to her husband. The remainder of her estate passes to her husband.

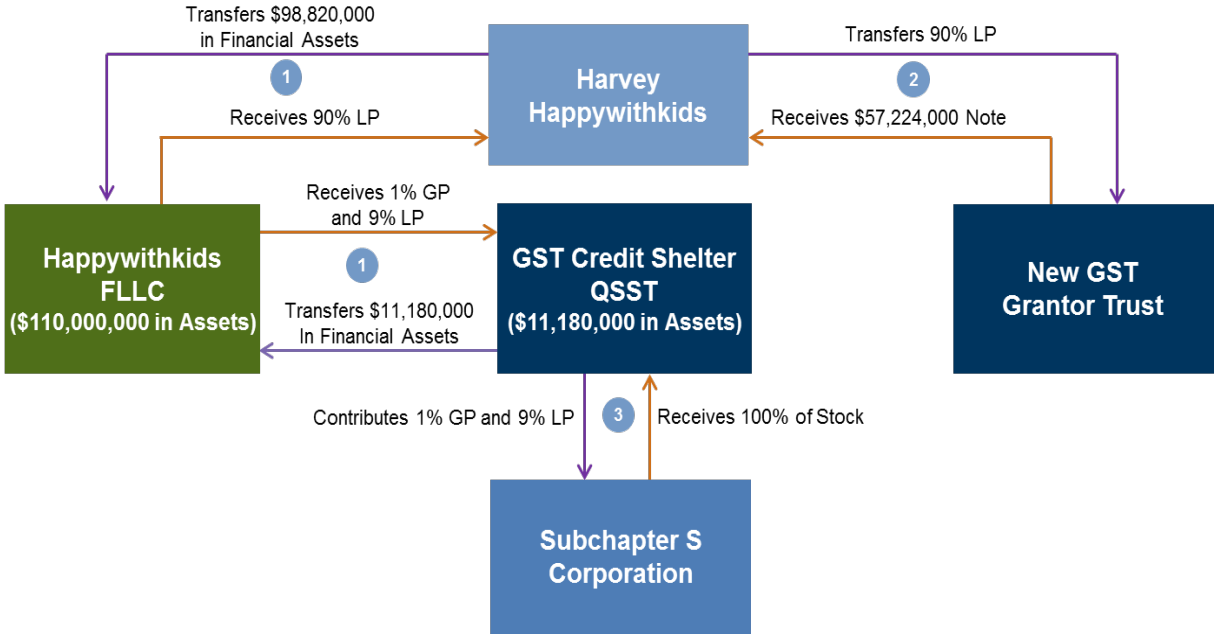
Consider the following example in which the credit shelter trust and the surviving spouse form a FLP together. The credit shelter trust then contributes its share of the partnership to a subchapter S corporation and the credit shelter trust becomes a QSST. The surviving spouse could use the unified credit to create a new grantor GST trust and could sell his remaining partnership interest to the new grantor trust.

Example 23: Harvey Happywithkids and a Credit Shelter Trust Create a FLP, the Credit Shelter Trust Contributes its Partnership Interest to a Subchapter S Corporation, the Credit Shelter Trust Becomes a QSST, and Harvey Gifts and Sells His Partnership Interest to a New Grantor Trust

Helen Happywithkids dies with a substantial $110,000,000 estate that is largely liquid, but has a low basis. Her husband, Harvey, has $1,000,000 in liquid assets. Helen's will bequeaths $11,180,000 to a GST credit shelter trust and the rest of her estate to Harvey. Harvey is the trustee of the credit shelter trust that distributes all of its income to Harvey and has a special power of appointment.

Harvey asks his attorney, Susie Cue, if she has any ideas on how to eliminate the future estate tax after his death. Harvey is very happy with his descendants and the ability to change the objects of his bounty is not important to him. Harvey asks Susie to assume he will live 10 years. Harvey also tells Susie that the liquid assets will annually earn a 7.4% pre-tax return during that 10-year period with 0.6% of the return being taxed at ordinary rates, 2.4% of the return being tax-free and 4.4% of the return being taxed at long-term capital gains rates with a 30% turnover. Harvey tells Susie that he will need around $1,000,000 a year (inflation adjusted) for his consumption needs. Susie assumes a 30% valuation discount is appropriate in valuing the limited partnership interest.

Susie Cue does have a plan. Susie suggests that the credit shelter trust and Harvey contribute their collective assets to an FLLC (Transaction 1 below). Harvey will then gift (using his unified credit) and sell his non-managing interests to a grantor trust that is also a GST trust pursuant to a defined value allocation assignment (Transaction 2 below). The credit shelter trust will contribute its partnership interest to a subchapter S corporation and the credit shelter trust will become a QSST (Transaction 3 below). The technique is illustrated below:



2. Income tax and basis enhancing advantages of the technique.

a. There is a step-up in basis of the deceased spouse's assets at her death.

b. There is an opportunity through using borrowing strategies from third party lenders for the surviving spouse to increase the basis of the family's assets during his lifetime.

The surviving spouse could substitute cash for any assets owned by Holdco that appreciate during his lifetime. *See supra* Section VIII. It is much more difficult to use borrowing strategies to enhance the basis of trust assets in a complex trust.

c. All of the income tax advantages of a SIDGT are present with this technique.

See supra Section III.B.

3. Transfer tax advantages of the technique.

a. Significant estate taxes can be saved with this technique.

Susie wants to compare planning with a traditional credit shelter trust that is taxed as a complex trust with a credit shelter trust that is taxed as a grantor trust, because the credit shelter trust becomes a QSST that owns Subchapter S stock. The context of the comparison is a creation of an FLLC by the surviving spouse who sells and gives his units to a grantor trust he creates. *See* Schedule 20 attached and the table below:

Table 16

	Beneficiaries		Consumption		IRS Income Tax			IRS Estate Tax (@ 40%)	Total
	Happywithkids Children (1)	Happywithkids Children & Grandchildren (2)	Direct Cost (3)	Investment Opportunity Cost (4)	Direct Cost (5)	Investment Opportunity Cost (6)	Embedded Capital Gains Tax (7)	(8)	(9)
10-Year Future Values									
Traditional Credit Shelter Planning: First to die spouse creates a credit shelter trust with her unified credit and balance of estate goes to a marital deduction trust	$95,044,358	$34,357,075	$11,203,382	$4,344,673	$13,238,320	$4,690,485	$414,058	$63,362,905	$226,655,255
	$129,401,432		$15,548,055		$18,342,862				
Traditional Credit Shelter Planning: First to die spouse creates a credit shelter trust; surviving spouse gifts and sells LLC interests to a new GST tax exempt grantor trust	$27,346,315	$142,293,544	$11,203,382	$4,344,673	$14,717,018	$4,690,485	$3,828,961	$18,230,877	$226,655,255
	$169,639,859		$15,548,055		$23,236,464				
Hypothetical Technique: first to die spouse creates a credit shelter trust that is converted to a QSST; surviving spouse gifts and sells LLC interests to a new GST tax exempt grantor trust	$27,346,315	$142,293,544	$11,203,382	$4,344,673	$14,717,018	$4,690,485	$3,828,961	$18,230,877	$226,655,255
	$169,639,859		$15,548,055		$23,236,464				

b. Under this example, Harvey Happywithkids has a considerable safety net of being a beneficiary of the GST credit shelter trust QSST, if he ever needs those resources.

c. Under this example, Harvey Happywithkids does not have to be paid back an equitable adjustment equal to the principal of the note, as is the case with a sale to a QSST.

d. It has all of the advantages of converting a complex trust to a QSST.

See discussion *supra* Section IX.B.

e. It has all of the transfer tax advantages of a SIDGT.

See discussion *supra* Section III.

f. Since under this technique, there is not a sale to a trust in which the seller is a beneficiary, there is much less IRC Secs. 2036 and 2038 pressure on the technique.

4. Considerations of the technique.

a. The surviving spouse only has flexibility to change the beneficiaries of the GST credit shelter QSST (assuming the surviving spouse has a power of appointment over the trust) and any assets the surviving spouse owns (which may be significantly depleted by the time of his death).

Thus, this technique lacks the flexibility to change beneficiaries because of changed circumstances in comparison to techniques in which the surviving spouse sells assets to a trust in which the surviving spouse is a beneficiary and has a power of appointment, the surviving spouse has the significant flexibility to redirect assets if circumstances change.

b. This technique has the same considerations of converting a complex trust to a QSST.

See discussion *supra* Section IX.B.3. Some of the income tax considerations of having a subchapter S corporation could be mitigated if the subchapter S corporation owned a preferred interest in the partnership.

c. This technique has the same considerations as sales of limited partnership interests to a grantor trust.

See discussion *supra* Section III.C.

D. Both the Credit Shelter Trust and the Marital Deduction Trust Could Be Designed to Be a BDOT For The Benefit of the Surviving Spouse; Both Trusts Contribute Their Assets to a FLLC; and, After That Contribution, the Marital Deduction Trust Could Sell Its Member Interests in the FLLC to the Credit Shelter Trust.

1. The technique.

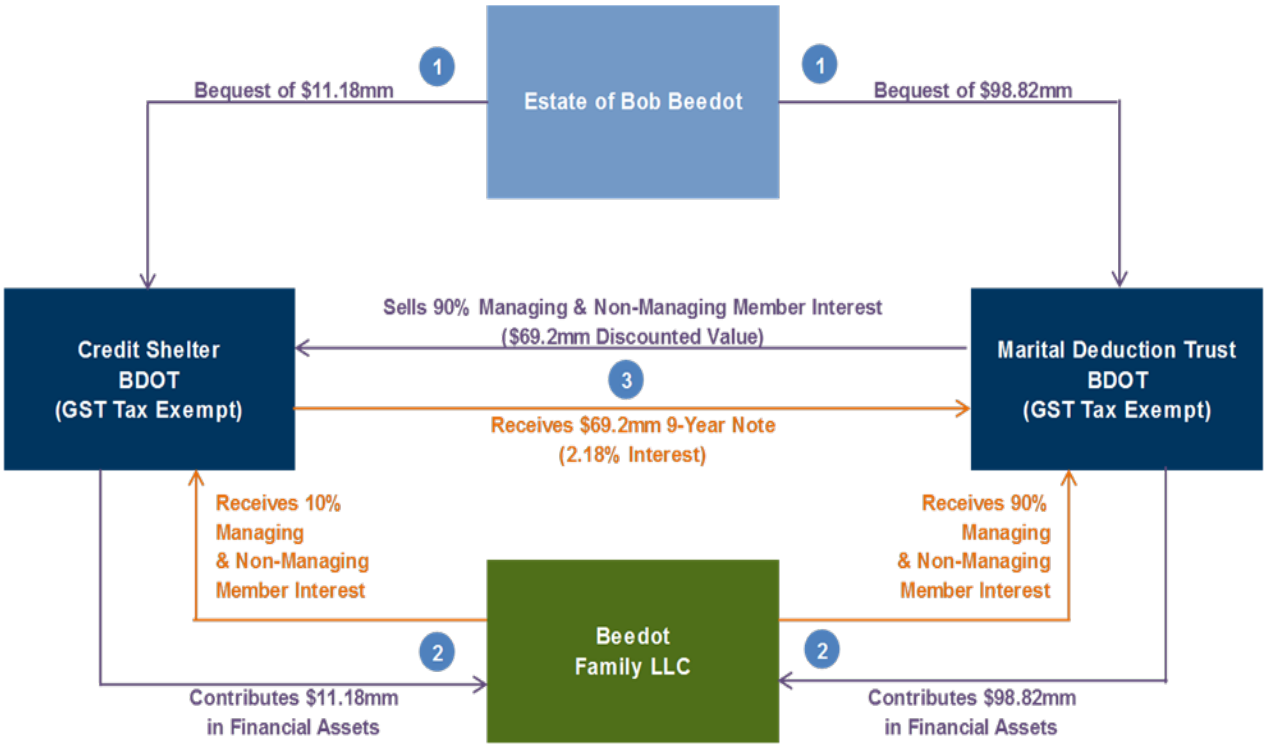
If both the credit shelter trust and the marital deduction trust are designed to be BDOTs with respect to the surviving spouse, then any sales between the two trusts will be ignored for income tax purposes. A discount entity could be created by those trusts and perhaps the surviving spouse. If the marital deduction trust sells its interest in the entity to a credit shelter trust that sale will be ignored for income tax purposes and all of the future collective appreciation above the interest owed to the marital deduction trust will pass to the credit shelter trust. The surviving spouse will pay all of the collective income taxes associated with the structure. The surviving spouse could look to the assets of the marital deduction trust for her living expenses and income tax expenses, which could deplete the marital deduction trust during the surviving spouse's lifetime, if those distributions exceed the marital deduction trust's interest income. Consider the following:

Example 24: Designing Both a Credit Shelter Trust and a Marital Deduction Trust to Be a BDOT in Order to Use Leveraged Grantor Trust Planning With Both Trusts

Bob Beedot is married to Dot Beedot. Bob has been very successful and he has built a $110,000,000 estate during their 50-year marriage. His first goal, if Dot survives him, is to totally provide for Dot. Upon Bob's death, Dot wishes for her remaining estate to pass in trusts to their descendants. Bob has never engaged in lifetime gifting strategies for a variety of reasons, one of which is that he has very low basis assets. Bob likes the protection, tax benefits and simplicity of the credit shelter trust and the marital deduction trust that could be created on his death. However, Bob is concerned that the credit shelter trust only protects about one tenth of his net worth from future estate taxes and creditors. Bob is intrigued about the possibility of designing the credit shelter trust and the marital deduction trust to be BDOTs, and the use of discounted sales between the trusts.

Bob tells his attorney, Youra Mathgeek, that Dot will need approximately $1,000,000 a year (inflation adjusted) for her consumption needs. Bob asks Youra to make the following assumptions: his assets will annually earn 7.4% before income taxes with 0.6% of the return not being tax free, 2.4% of the return being taxed at ordinary rates and 4.4% of the return being taxed at long-term capital gains rates (with a 30% turnover rate). Bob asks Youra to assume Dot will live for 10 years after his death.

Youra suggests to Bob that after his death the trusts could create a single member FLLC with managing and non-managing interests (Transactions 1 and 2 below). The marital deduction trust could sell its interests to the credit shelter trust (Transaction 3 below). Youra assumes a 30% valuation discount for the non-managing interests will be allowed. The structure, after completion, is illustrated as follows:



2. Income tax and basis enhancing advantages of the technique.

   a. There is a step-up in basis of the deceased spouse's assets at his death.

This technique is particularly advantageous for a taxpayer who has a low basis or a negative basis asset, because it does not require a lifetime transfer of assets. There will be a step-up in basis that is equal to the fair market value of the assets.

   b. There is an opportunity through using borrowing strategies from third party lenders for the surviving spouse to increase the basis of the family's assets during her lifetime.

The surviving spouse could substitute cash for any assets owned by Holdco that appreciate during her lifetime. See supra Section VIII.B. It is much more difficult to use borrowing strategies to enhance the basis of trust assets in a complex trust.

   c. All of the income tax and basis enhancing advantages of creating a LAIDGT are present with this technique.

See discussion supra Section IV.B.

3. Transfer tax advantages of the technique.

a. Significantly more assets may be passed to the next generation by using this technique than using the exemption to fund a credit shelter trust that is taxed as a complex trust and a marital deduction trust that is taxed as a complex trust.

Using the synergies of a discounted sale of the marital deduction trust's non-member interests to the credit shelter trust and paying the notes with pre-income tax dollars, is a much more powerful planning technique than a transfer to complex trusts that pay their own income taxes. This technique, once again, demonstrates the synergistic power of discounted sales to trusts that are treated as grantor trusts.

Youra's calculations indicate that $44,299,632 in estate taxes could be saved with this technique, assuming Dot lives 10 years after the death of Bob in comparison to traditional credit shelter and QTIP planning. Youra's calculations also indicate that $6,335,369 in additional estate tax savings could accrue with this technique, assuming Dot lives 10 years after the death of Bob, if an interest in a discounted entity is sold by the trustee of the marital trust to the credit shelter trust, with both trusts being complex trusts. See the table below and attached Schedule 21.

Table 17

	Beneficiaries		Consumption		IRS Income Tax			IRS Estate Tax (@ 40%)	Total
	Beedot Children (1)	Beedot Children & Grandchildren (2)	Direct Cost (3)	Investment Opportunity Cost (4)	Direct Cost (5)	Investment Opportunity Cost (6)	Embedded Capital Gains Tax (7)	(8)	(9)
10-Year Future Values									
Traditional Credit Shelter Planning: first to die spouse creates a credit shelter trust with his unified credit and balance of estate goes to a marital deduction trust	$86,124,803	$32,858,879	$11,203,382	$4,344,673	$23,662,299	$8,610,683	$392,061	$57,416,535	$224,613,316
	$118,983,682		$15,548,055		$32,665,044				
Traditional Credit Shelter Planning: first to die spouse creates a credit shelter trust and balance of estate goes to a marital deduction trust; the credit shelter trust and the marital deduction trust create an LLC; the marital trust sells LLC interest to the credit shelter trust	$29,178,407	$123,128,879	$11,203,382	$4,344,673	$25,054,497	$8,610,683	$3,640,523	$19,452,272	$224,613,316
	$152,307,286		$15,548,055		$37,305,703				
Hypothetical Technique: first to die spouse creates a credit shelter trust, that is a BDOT, and a marital deduction trust, that is also a BDOT; the credit shelter trust and the marital deduction trust create an LLC; the marital deduction trust sells LLC interests to the credit shelter trust	$19,675,355	$139,000,798	$11,203,382	$4,344,673	$25,044,447	$8,610,683	$3,617,074	$13,116,903	$224,613,316
	$158,676,153		$15,548,055		$37,272,205				

b. The surviving spouse's rights with respect to assets owned by the BDOT, and cash flows produced by those assets, are substantial.

4. Considerations of this BDOT post-mortem technique.

a. This technique has the same considerations as the creation of a BDOT and sale to a BDOT.

See discussion supra Section IX.C.4.

b. This technique has the same considerations as the SIDGT technique.

See discussion supra Section III.C.

c. Like all leverage techniques, if the underlying assets stay flat or decline there is not any advantage to the technique and to the extent a gift tax exemption is used, the technique operates at a disadvantage.

d. The marital trust must also give the surviving spouse the right to withdraw all the trust's accounting income for life in addition to giving the surviving spouse the right to withdraw the net taxable income for life. A spouse's right to withdraw accounting income satisfies the regulations applicable to marital trusts, including QTIP trusts. *See* Treas. Reg. §§20.2056(B)-5(F)(8) and 20.2056(B)-7(D)(2). Another alternative is to give the surviving spouse the right to withdraw the net taxable income and to require the accounting income to be distributed. If accounting income is required to be distributed, and if the surviving spouse is also given the right to withdraw the net taxable income, does the trust remain a wholly grantor trust under IRC Sec. 678 because of the spouse's power to withdraw net taxable income? The answer should be yes, because the grantor trust rules prevail over the otherwise applicable trust rules. *See* Treas. Reg. §1.671-2(d).

XIV. USING PARTNERSHIP STRUCTURES TO ACHIEVE DIVERSIFICATION WHILE DELAYING THE TAX ON THAT DIVERSIFICATION IN ORDER TO ACHIEVE GREATER PRE-TAX COMPOUNDING.

A. Use of Multi-Owner Exchange Funds.

1. The technique.

The exchange fund is a technique for a taxpayer to consider if he has accumulated highly appreciated stock positions and desires both tax deferral and immediate economic

diversification. The strategy needs to be carefully implemented in order to prevent participants from recognizing capital gains due to their participation in the fund.

The exchange fund concept can be applied in many ways through the use of a partnership, but for purposes of the analysis under this Section XIV, the exchange fund is bifurcated into two categories, the "multi-owner," or exchange fund (*see* discussion *infra* Section XIV.A), and the "closely-held family structure" techniques (*see* discussion *infra* Section XIV.B).

At its very essence, the exchange fund concept entails the contribution of multiple appreciated marketable security positions from multiple owners in a single partnership in combination with certain non-marketable assets. If certain conditions are met pursuant to IRC Secs. 721, 351, 704(c), 737, 707, 731(c), and 732,[199] then the contribution of the appreciated position by the original owner and the ultimate receipt of non-cash, marketable assets upon liquidation, will not cause a capital gain recognition event to the owner.

Example 25: The Use of Multi-Owner Exchange Funds

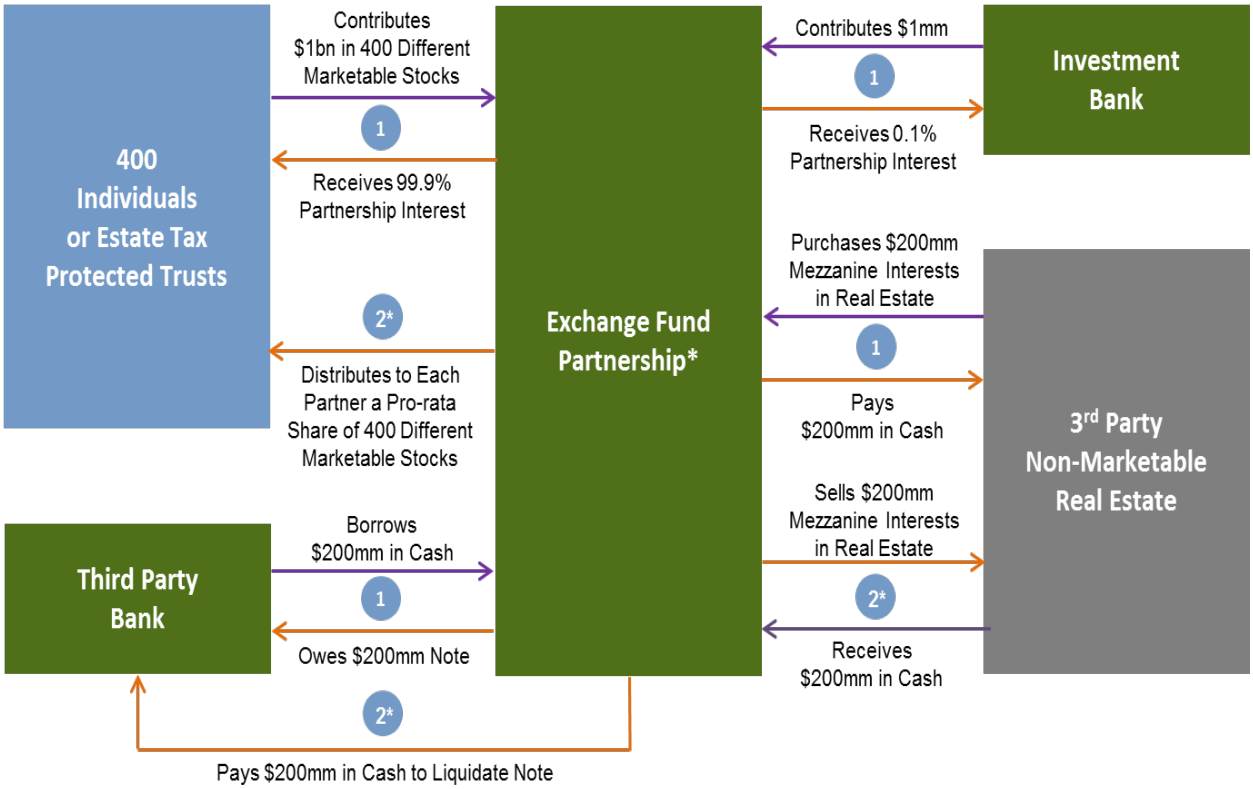
Four hundred unrelated individuals contribute 400 different marketable stocks to a partnership in which an investment bank is the managing partner. The marketable stock is used to provide for security for a loan equal to 20% of the value of the contributed stock. The proceeds of the loan are used to purchase a mezzanine interest in various real estate properties. The stocks that are accepted into the partnership are designed to be correlated to the Russell 1000 Index. The partnership is designed to last for 20 years. The investment bank charges an annual fee equal to 0.85% of the value of the partnership assets. None of the partners withdraw prior to seven years after the creation of the partnership. Each partner contributes significant positions in 400 different marketable stocks that are collectively worth $1 billion. After the partnership is formed several partners transfer his or her interests to estate tax protected trusts ("Transaction 1").

Seven years and a day later, all of the partners decide to withdraw from the partnership and receive a diversified portfolio appropriate for their sharing ratios. The mezzanine interests in the real estate properties are sold and the third party loan is liquidated ("Transaction 2").

The partners believe at the time of their withdrawal that no capital gains consequences will accrue under current law.

The technique is illustrated below:

[199] For discussion of those IRC Sections, see *supra* Section II.A.1.b.



3* – 7 years and 1 month after the Exchange Fund Partnership is created, the following occurs: (i) the partnership sells its mezzanine interest in real estate for cash; (ii) the partnership liquidates the debt owed to the 3rd Party Bank; and (iii) the partners liquidate their interest in exchange for their pro-rata interest in each stock owned by the partnership.

* Each transaction must be independent, separate and distinct.

2. Income tax advantage of the technique.

a. The owner of the exchange fund will achieve diversification of his portfolio that has much less volatility, and achieve a seven-year or longer delay in paying a capital gains tax for that diversification.

Many investment firms market the exchange fund partnership to multiple clients and collect many securities upon formation. In effect, the exchange fund simulates a mutual fund concept that is designed to track the Russell 1000 Index and which can provide an equity investment alternative to its participants.

Once the partnership terminates, the owner of the exchange fund could sell those securities he or she does not wish to own and keep the rest. The cash proceeds of the stock that is sold could be reinvested in the securities the taxpayer does wish to own. If the owner is a grantor trust, the grantor of the trust will pay the tax on those sales. Thus, diversification occurs immediately for the stock contributed to the exchange fund. There is a seven-year delay in tax on the resulting portfolio on termination of the partnership for the stock that is to be sold, with a longer delay in tax on those securities that are not sold. Using the borrowing techniques discussed *supra* Section VIII, there may be tax elimination on the securities that are not sold at

the end of seven years. There may also be capital gains tax elimination on any securities that are subject to estate taxes in the taxpayer's estate.

3. Considerations of the technique.

a. Care needs to be taken to make sure there is not a deemed sale on the formation of the partnership under IRC Sec. 721.

See the discussion of IRC Sec. 721 *supra* Section II.A.1.b.(3).

As the above discussion indicates, the ultimate test under IRC Sec. 721 in this context is one of both diversification and not violating the 80% marketability test. Under the facts of this Example 26, the individual participants have diversified their holdings through the formation of the partnership. However, the formation of the partnership should not constitute a taxable event to the participants because less than 80% of the assets of the partnership are marketable due to the non-marketable real estate assets held by the Exchange Fund partnership.

b. Care should be taken to make sure IRC Secs. 704(c), 737 and 707 do not apply.

See discussion *supra* Section II.A.1.b.(5) about the disguised sales rules under subchapter K.

Under the facts of this example, the facts and circumstances test of the two-year rule of a partner receiving money on other consideration should not be applicable. *See* IRC Sec. 1.707.3(b)(2).

In this example, several individuals, the trust and the investment bank remain in the partnership for seven years without selling any of the appreciated marketable securities, then any transactions involving the distribution of the securities to the partners should not result in a taxable gain pursuant to IRC Sec. 704(c).

c. Care should be taken to make sure the liquidation of the partnership occurs in seven years will not be subject to tax under IRC Secs. 731(c) and 732.

See discussion *supra* Section II.A.1.b.(6) and (7).

Upon the liquidation of a partner's interest, to the extent that partner receives money above the partner's basis in the partnership, the partner will be taxed. Thus, the issue of "money" is pertinent to the extent it is distributed to a partner in excess of his basis. However, if securities are distributed in lieu of cash, then perhaps such a gain can be avoided. Presumably, a exchange fund partnership such as Example 26 would meet the definition of investment partnership pursuant to IRC Sec. 731(c), which is a different definition from the 80% test imposed by IRC Sec. 721, and as such, the distribution of securities should not create a taxable event.

d. Each partner's basis in the assets that each partner receives on liquidation will equal that partner's total outside basis of the liquidated partnership interest.

See discussion *supra* Section II.A.1.b.(7).

Under Example 26, if the exchange fund partnership operates for seven years without the sale or disposition of the contributed appreciated securities, then upon liquidation, each partner could receive an approximate 20% interest in all of the underlying partnership assets without the imposition of a capital gains tax. Only when an individual partner sells his distributed assets will that partner recognize capital gains. Under the facts of Example 26, the partnership has provided each partner with the potential of asset diversification and tax deferral.

e. There are economic considerations in using exchange funds.

The economic limitations of the exchange fund are the following:

(1) The lack of liquidity (there may be a six month or longer notice period before a partner can withdraw);

(2) The financial management fees and third party bank loan interest may exceed the profits on the real estate investment;

(3) The desire of the fund manager to accept certain securities than an investor would otherwise not invest;

(4) The performance of the other securities accepted into the fund over the seven-year period; and

(5) The taxpayer may only be able to diversify a limited amount of his single stock position because of limitations inherent in accepting stock from several taxpayers.

B. Using Closely Held Family Partnerships to Achieve Diversification and to Defer and Lower Income Taxes By Using Various Forms of Mixing Bowl Transactions.

1. The techniques.

One of the most powerful modern estate planning tools is the use of family limited partnerships to obtain valuation discounts for transfer tax purposes. If properly structured a family limited partnership can lead to substantial transfer tax savings. Not only can a family limited partnership lead to substantial transfer tax savings, it can also lead to substantial income tax benefits if the family owns low basis assets and the family limited partnership lasts seven or more years. The concepts outlined above that address the formation and management of a multi-owner exchange fund can certainly exist within the framework of a privately-managed partnership with a limited number of partners, perhaps all within the same family. There are no prohibitions among related-party transactions that would impact any of the previously mentioned

statutes and regulations. A variety of techniques, sometimes called "mixing bowl" techniques have been developed over the years using privately-managed partnerships, contributions by partners, withdrawals by partners, loans to partnerships and/or loans to partners to substantially delay the taxation associated with diversifying the partners' investments. However, in a closely-held partnership, attention should be given to the Treasury regulations under IRC Sec. 701 (the so-called "anti-abuse" rules). However, as previously discussed, basis enhancing strategies based on the Subchapter K provisions generally appear to be in compliance with IRC Sec. 701. *See* discussion *supra* Section II.A.1.b.(5).

In some cases, from the IRS point of view, these techniques constitute disguised sales. The IRS, in a series of cases from 1978 to 1983, challenged some of these techniques using certain common law tax doctrines. During this period, the IRS had several significant losses.[200] This lead to the Tax Reform Act of 1984 in which many of the mechanical rules of subchapter K, which are noted in the prior discussion *supra* Section II.A.1.b, were adopted. If these rules are followed tax delayed diversification and basis shifting may occur.

Examples of those closely-held family structure techniques, which are two of many, are discussed in Examples 26 and 27 below[201]. In these examples the estate tax savings associated with using a family partnership are preserved and diversification is achieved while potentially significantly ameliorating and/or deferring the income tax costs of that diversification.

Example 26: Diversifying a "0" Basis Single Stock to a
Diversified Portfolio by Paying an Initial 2.38% Tax Instead of a 23.8% Tax

A little over seven years ago, Don and Donna Diversified entered into a leveraged reverse freeze planning transaction. Don and Donna contributed only one stock, Single Stock, Inc., which had a value of $100,000,000, to the partnership in exchange for a general partnership interest, and "growth" and "preferred" limited partnership interests, with the preferred interest having a 10% coupon (Transaction 1) and a par value of $90 million. The stock had a "0" basis on its contribution. Don and Donna, right after the partnership was created, gifted and sold their $90 million par preferred interest to a grantor trust for their descendants (Transaction 2). The 10% coupon was serviced by dividends and sales of Single Stock, Inc. from time to time.

[200] *See Otey v. Commr.*, 70 T.C. 312 (1978), aff'd per curium 634 F.2d 1046 (6th Cir. 1980); *Communication Satellite Corp. v. U.S.*, 625 F.2d 997 (Ct. Cl. 1980); *Park Realty Co. v. Commr.*, 77 T.C. 412 (1981), acq. 1982-2 C.B. 2; and *Jupiter Corp. v. U.S.*, 2 Cls Ct 58 (1983).

[201] *See* Abrams, Howard "Now You See It; Now You Don't: Exiting a Partnership and Making Gain Disappear" (February 16, 2009, Vol. 50, No. 04 TM Memorandum (BNA)).

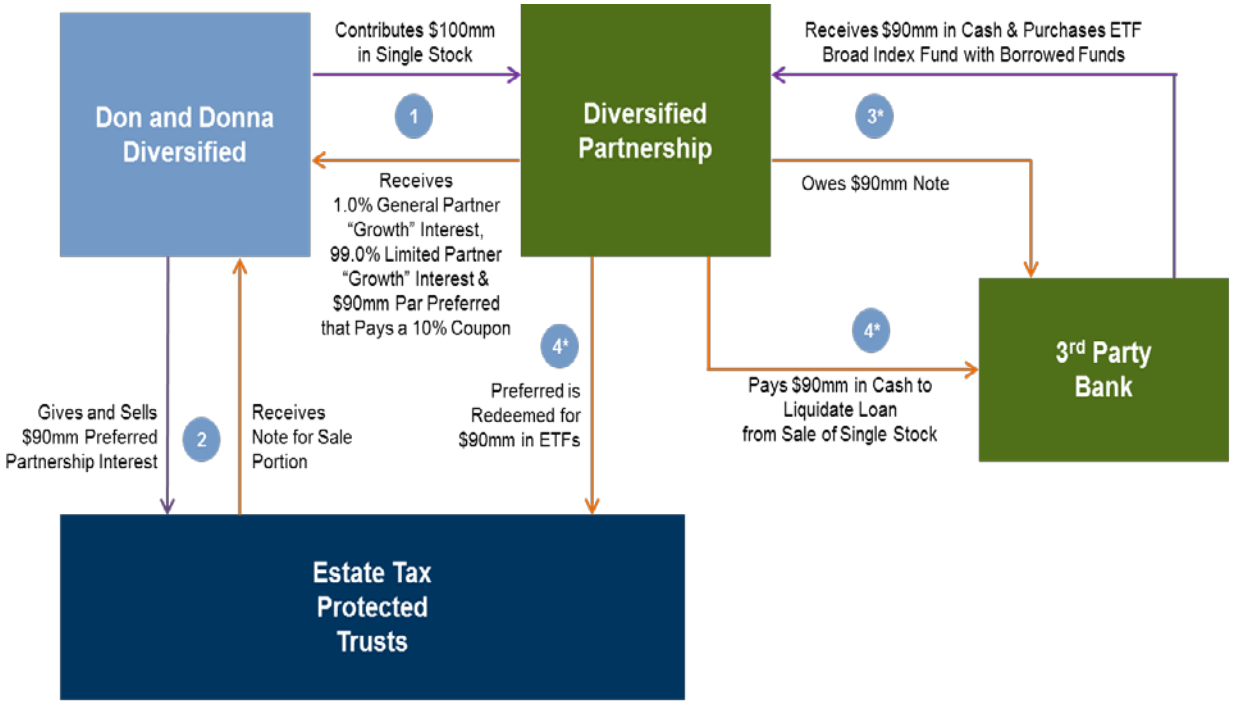
After seven years the note owed by the grantor trusts was extinguished. At that point the grantor trust status of the trust was terminated. After that termination, the partnership still had $100,000,000 in value of the Single Stock, Inc. stock. The partnership then borrowed $90,000,000 in cash from a third party lender. The $90,000,000 loan was guaranteed by Don and Donna who also posted additional personal assets, besides the partnership assets to secure the loan. The partnership paid an appropriate guarantee fee to Don and Donna. Under this example, it is assumed, under IRC Sec. 752, that the loan is properly allocated to Don and Donna under partnership tax accounting principles. The partnership used the $90,000,000 in loan proceeds to purchase a broad based market index ETF fund (Transaction 3).

The partnership then redeems the $90,000,000 par preferred interest that is held by the non-grantor trust with the $90,000,000 basis diversified ETF fund. After that transaction is completed the partnership then sells the $100,000,000 worth of Single Stock, Inc. stock and uses 90% of the sale proceeds to liquidate the third party lender debt and ten percent (10%) of the sale proceeds to invest in bonds and an ETF that correlates with a broad based market index. The partnership makes an IRC Sec. 754 election and the $90,000,000 basis that is stripped out of the ETF used for redeeming the trust's preferred interest (because the ETF will take on a new basis of "0", which is equal to the trust's outside partnership basis of "0") is allocated to the partnership's ownership of $100,000,000 in Single Stock, Inc. (Transaction 4).

By entering into this selling and liquidation strategy the partners are able to sell $100,000,000 of Single Stock, Inc. and diversify into a broad based diversified ETF and only owe $2,380,000 in immediate capital gains taxes and will collectively own $97,620,000 in that fund with a collective basis of $7,500,000.

If the partnership had not entered into this technique and instead had sold all of the Single Stock, Inc. stock and invested the sale proceeds after taxes in the ETF fund (assuming a 23.8% tax rate), the partnership would own $76,200,000 of the ETF with a collective basis of $76,200,000. It should be noted that if this technique is adopted, and if the trust for Don and Donna's descendants decides to sell at a later time its $90,000,000 ETF investment and invest the proceeds in other investments, the partners and former partners will also collectively own $76,200,000 of assets (assuming no growth in the assets) with a $76,200,000 basis. Thus, the power of the technique is deferral of income taxes and the power of pre-tax compounding. This technique does not eliminate the inherent capital gains tax.

A diagram of the technique is illustrated below:



3* – After 7 years and 1 month, it is assumed (i) that the note owed to Don and Donna Diversified by the Estate Tax Protected Trusts has been paid; (ii) the grantor trust status is removed from the trusts and the trusts become complex trusts; (iii) the Diversified Partnership borrows $90mm from a 3rd Party Lender and invests $90mm in ETFs.

4* – The $90mm preferred interest is redeemed for the ETFs and the partnership sells the $100mm Single Stock in order to pay off the 3rd party note.

*Each transaction must be independent, separate and distinct.

Also consider this example:

Example 27: Diversification Planning With a Closely Held Family Partnership While Preserving the Transfer Tax Advantage of a Closely Held Family Partnership and Paying a 9.64% Capital Gains Tax Instead of a 23.8% Capital Gains Tax

In 2005, Sam Singlestock contributed $8,500,000 worth of marketable stock (Marketable Stock, Inc.), with a cost basis of $0 to Growing Interests, Ltd. for an 85% limited partnership interest. His daughter, Betsy Bossdaughter, contributed $750,000 worth of Marketable Stock, Inc., with a cost basis of $0 and his son, Sonny Singlestock, contributed $750,000 worth of Marketable Stock, Inc., with a cost basis of $0 to the partnership and each received a .5% general partnership interest and a 7% limited partnership interest. The initial sharing ratios of the partners are Sam 85%, Betsy 7.5%, and Sonny 7.5% ("Transaction 1"). In 2011, using a financial engineering technique, the Marketable Stock, Inc. stock owned by the partnership is hedged, and the partnership is able to obtain $5,950,000 in cash, in the form of a cash loan from Investment Bank, Inc. Betsy and Sonny also agree to personally guarantee the note. The partnership invests the loan proceeds in a nonmarketable $5,950,000 real estate investment, which is used with the other partnership assets as security for the loan ("Transaction 2").

A few years later (2013), for family reasons and because the partners have significantly different views about the future investment philosophy of the partnership, Sam Singlestock wishes to withdraw from the partnership. There has been no growth in the partnership assets. A

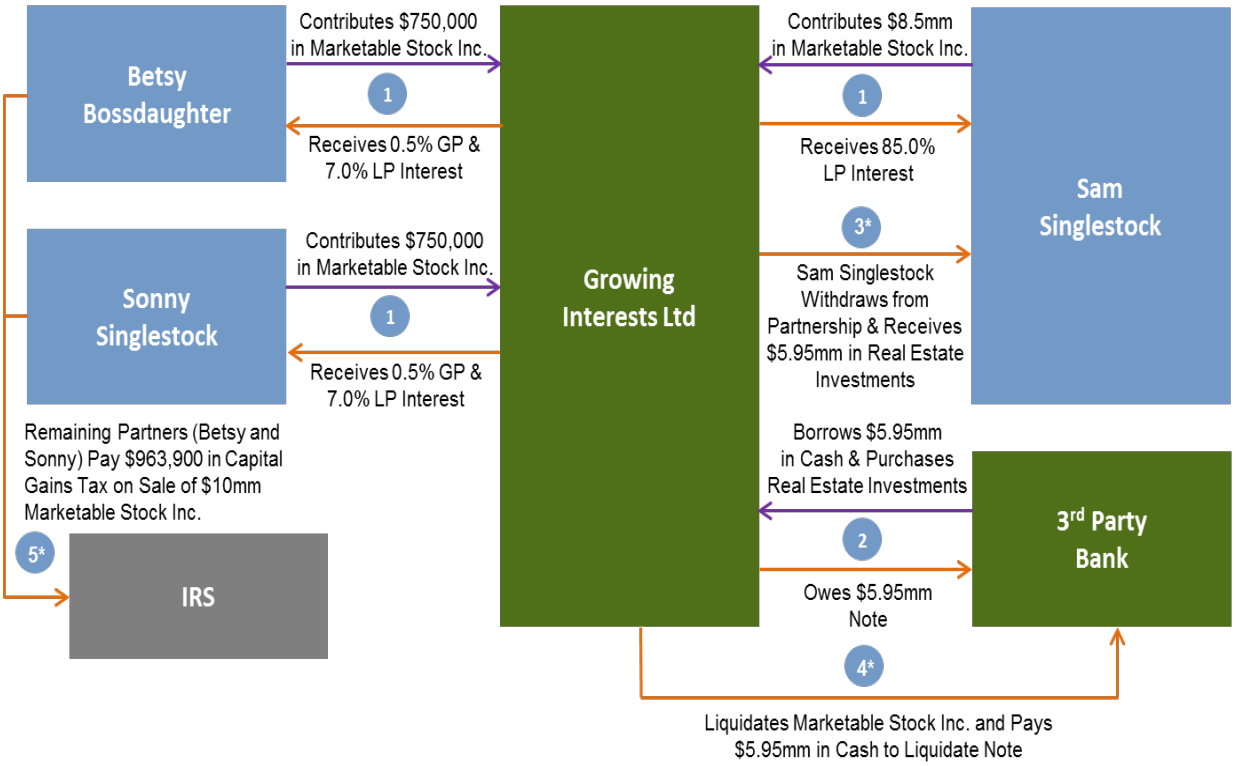
professional, independent appraiser determines that because of marketability and minority control discounts, Sam's limited partnership interest is worth $5,950,000. The partnership distributes the real estate investment worth ($5,950,000) in liquidation of his limited partnership interest. The partnership makes an IRC Sec. 754 election ("Transaction 3").

One year later (2014) the partnership sells enough of Marketable Stock to liquidate the $5,950,000 loan with the proceeds of the $10,000,000 sale ("Transaction 4").

After the partnership makes an IRC Sec. 754 election, the partnership's basis in the $10,000,000 Marketable Stock, Inc. is equal to $5,950,000. Thus, if all of the $10,000,000 in marketable stock is then sold to retire the $5,950,000 debt and diversify into other investments there will be $963,900 in capital gains taxes and Sec. 1411 taxes (assuming a then 23.8% rate). After the sale, the partnership and the remaining owners of the partnership, Betsy and Sonny, are left with $3,086,100 ("Transaction 5").

If the partnership had instead sold $10,000,000 of Marketable Stock, Inc., and not made the real estate investment, and then had liquidated, Betsy and Sonny would have been left with only $1,140,000 in cash as their part of the partnership after capital gains taxes. From the perspective of Betsy and Sonny the technique generates a 170.7% increased improvement.

The technique is illustrated below:



3*, 4* and 5* above happen more than 7 years after the creation of the partnership.

* Each transaction must be independent, separate and distinct.

2. Advantages of the family partnership mixing bowl techniques.

In addition to the discussion below, *see* discussion *supra* Section XIV.A.

a. Management fees do not have to be paid to a third party investment bank.

b. The income tax benefit of the withdrawal: the illustrated "family structure" opportunities can provide the family an ability to manage the position through an appropriate controlled legal entity, while offering the potential for a long-term exit strategy that can be accomplished on a deferred tax basis.

In example 33 there will be no immediate tax consequences to the family trust diversifying its zero basis single stock position from its $90,000,000 position until the trust decides to sell part or all of its $90,000,000 diversified ETF position. In Example 27 the real estate investment will retain its zero basis without the imposition of a capital gains tax until it is sold, at which time Sam will recognize capital gains taxes. If Sam chooses to operate the real estate until his death, then IRC Sec. 1014 would apply upon his death and the real estate will receive a step-up in basis to its then fair market value. Betsy and Sonny, if the partnership makes an IRC Sec. 754 election, will receive a basis adjustment because of IRC Sec. 734(b) in the retained Marketable Stock that should allow the partnership to retire its debt with modest tax net consequences.

c. In comparison to the exchange fund, the illustrated mixing bowl techniques provide the retention of upside in the original appreciated position, albeit without diversification until the stock is sold, and without the lack of control with exchange funds.

d. Transfer tax benefit of a withdrawal from a long-term partnership structure.

In Example 26 the transfer tax benefits of the trust owning a 10% compounding preferred interest could be significant especially if the underlying stock does not grow at that same pace. In Example 27 the valuation discount associated with the liquidation of Sam's limited partnership interest, if it is accurate, will not result in a gift tax, even though the fair market value of the remaining partnership interests owned by Betsy and Sonny will increase in value. This is because the withdrawing partner, Sam Singlestock, under the assumptions, received full and adequate consideration.

e. The total potential transfer tax and capital gains tax savings may be significant.

The net result of the transactions in Example 26 is that only a 2.38% initial capital gains tax has to be paid instead of a 23.8% capital gains tax if the full zero basis $100,000,000 single stock is diversified. Furthermore, the transfer of benefits of the leveraged reverse freeze are preserved.

The net result of the transactions in Example 27 is that Betsy and Sonny's collective net worth (assuming a then 23.8% capital gains rate), after capital gains taxes and/or contingent capital gains taxes, will increase by 170.7%.

Furthermore, the valuation discount transfer tax advantage is preserved.

f. By use of partnership division techniques that are in compliance with IRC Sec. 708, partnership assets could be isolated where basis planning is most useful.

See discussion *supra* Section II.A.1.(b)(8).

g. A Taxpayer could use the techniques to diversify most of his position in a single stock.

3. Considerations of the techniques.

a. General considerations

The individual transactions comprised in each technique must be independent, separate, and distinct. They must avoid application of the partnership anti-abuse rules.[202] In Example 26, it is important that the partnership operate as an "investment partnership" within the meaning of IRC Sec. 731(c)(3)(A)(iii) to prevent the distributed ETF units from being treated as money under IRC Sec. 731(c)(1).

b. Are there any tax consequences on formation of the partnership in the above techniques?

Formation of the partnership should not be a taxable event under IRC Secs. 721 or 351, because there is not any diversification. Each partner is still exposed to the same original Marketable Stock, Inc. position. There should not be any gift tax consequences on the formation of the partnership.[203]

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[202] The anti-abuse rules are discussed *supra* Section II(A)(1)(b)(11). *See also Countryside Limited Partnership v. Commissioner*, TC Memo 2008-3 (the Tax Court found that partnership anti-abuse rules were not violated in a mixing bowl transaction). In general, the courts are reluctant to allow the IRS to use equitable tax doctrines to override the benefits the Internal Revenue Code clearly permits. *See Getlitz v. Commissioner*, 531 US 206 (2001) (the Supreme Court found for the taxpayer in which a literal application of the rules under subchapter S in the context of cancellation of debt income provided both a basis increase and an exclusion from income); *Summa Holdings, Inc. v. Commissioner*, No. 16-1712 (6th Cir. 2017); *Wright v. Commissioner*, 804 F.3d 877 (6th Cir., 2016); and *Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311 (5th Cir., 2015).

[203] Please *see* the discussion in the *Strangi* decision *supra* Section III.C.5.a.(2). Practically, the only tax issue every judge of the full Tax Court agreed upon in the *Strangi* decision is there is not a gift on formation of a pro rata partnership, even if every partner's interest is worth less after formation.

c. Are there any tax consequences when the partnership interests in Examples 26 and 27 are redeemed?

After formation, in order to properly diversify into another asset, while still allowing the family members to participate in the upside potential of the marketable stock, the partnerships in the above examples could hedge its position in the marketable stocks. The hedging strategies could either be structured as a single long-dated contract or multiple contracts over time that does not cause the original security to be sold for income tax purposes. The hedging could be accomplished through a collar with a margin loan, or a pre-paid variable share forward structure. The partnership could invest the cash in a new asset.

Assuming the partnership is seven years old, or older, the partnership can enter into the transactions of these examples without directly violating IRC Secs. 704(c), 737 and 731(c). Under the facts of these examples, due to family investment reasons, the partnership decides to redeem a partnership interest. In order to redeem that member, the partnership first determines the value of the redeemed partner's interest in the partnership. If the partnership redeems the redeemed partner's interest for cash, the partner will be subject to capital gain recognition under IRC Sec. 731(a). If the redeemed partner's interest is redeemed with a high basis ETF as in Example 26, or with high basis real estate, applying the rules of IRC Secs. 732 and 752, the redeemed partner would have a "0" basis in that property because that property assumes the "0" basis of the redeemed partner's interest. However, the redeemed partner would pay no immediate capital gains tax and the partnership, because of the application of IRC Sec. 734(b), would have an increased basis in its remaining assets equal to the stripped basis of the asset used in redeeming the withdrawing partner as in Example 27.

The partnership portfolio is still subject to the note payable to the third party lender that must be repaid at some time in the future. The partnership could make an IRC Sec. 754 election after the redemption of the withdrawing partner's interest, and because of IRC Sec. 734(b) the remaining marketable stock would receive a proportionate basis adjustment. The partnership could sell enough of the remaining assets to eliminate the debt. The sale of the partnership assets by the partnership may result in a much smaller taxable gain than if the redemption and the IRC Sec. 754 election had not occurred.

d. There is exposure that Congress could change the law, by the time a partner withdraws (e.g., IRC Secs. 732 or 752 of the Code could be amended) and that the favorable liquidation rules would no longer be available. There is also exposure in that the IRS could change its regulations.

For instance, the IRS has recently proposed changes to its regulations under IRC Sec 752 to address perceived abuses associated with the so-called popular "leveraged partnership" technique. Under this technique, one partner contributes a business and receives a small interest in the partnership and the proceeds from a borrowing incurred by the partnership shortly after its formation. Generally in a transaction where a partner contributes property and receives shortly thereafter cash from the partnership, the receipt of the cash will be treated as a disguised sale under IRC Sec. 707. There is an exception, if the partnership borrows funds from a third party

and that borrowing is fully allocable to the "business contributing" partner in a properly structured transaction. With a properly structured transaction, the gain from the simulated sale is deferred until the earlier of the partnership terminating or the loan being repaid. The key to the success of the leveraged partnership technique is for the entire partnership liability to be properly allocable to the "business contributing" partner who receives the proceeds of the third party loan to the partnership.

The proposed regulations will change how certain of the leveraged partnerships have been structured in the past. (*See* proposed Treas. Reg. §§1.752-2(b) and 1.752-2(f)). For instance, under the proposed regulation changes, if a limited partner guarantees a recourse liability the guarantor's share of the recourse liability will be zero, if the general partner has net value sufficient to satisfy the obligation. Another change is that certain guarantees will not work, if they are so-called "bottom dollar guarantees." Another example of a proposed change occurs if a partner agrees to indemnify the first losses that the "business contributing" partner may have as guarantor on a partnership debt. Under those circumstances the guarantee will not work.

e. Like all leverage techniques, if the underlying assets stay flat or decline there is not any advantage to the technique and to the extent a gift tax exemption is used, the technique operates at a disadvantage.

f. If these techniques are used it will take at least seven years of partnership aging before the "safety" of diversification can be used.

This should be contrasted with a multi-party exchange fund as illustrated in Example 25 where that diversification can be achieved immediately. However, there is also a seven-year wait before a partner receives liquid assets.

C. The Use of a Retained Preferred Partnership Interest in a FLLC and Third Party Leverage to Generate Effective Estate Planning and Basis Planning.

1. The technique.

Borrowing against low basis assets and using the loan proceeds in estate planning transactions is a popular alternative to achieve a step-up in basis on the death of a taxpayer and also mitigate the taxpayer's estate taxes. One form of that technique is for a taxpayer who owns assets that are highly appreciated (e.g., depreciated real estate) to consider creating a single member limited liability company with preferred and growth member interests. The preferred interest coupon could be cumulative and could be paid in cash or in kind. The taxpayer could contribute the zero basis asset to the single member limited liability company in exchange for a preferred interest. The taxpayer could contribute cash that the taxpayer owns, or borrows, to the single member limited liability company in exchange for the "growth" interests. The taxpayer could then engage in advanced gifting techniques to remove the growth interests from her estate. Consider the following example.

Example 28: Use of a Leveraged Estate Freeze to
Obtain a Basis Adjustment at Death and to Save Estate Taxes

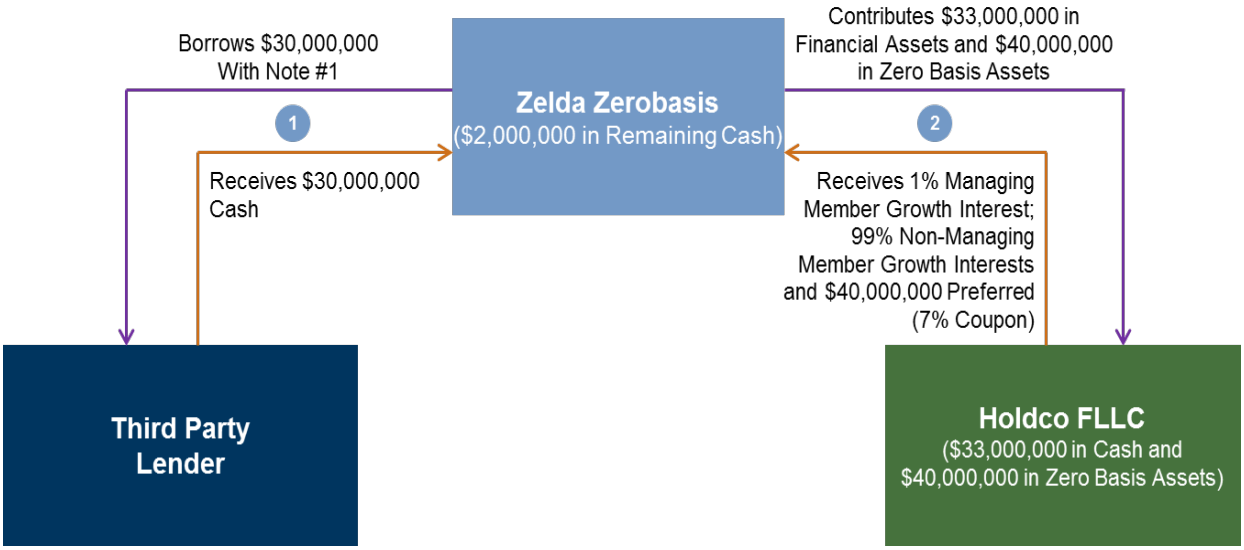
Zelda Zerobasis owns $40,000,000 in zero basis assets and $5,000,000 in cash or near cash assets that have full basis. She tells her advisor, Pam Planner, she wants a plan in which the following goals are met: (i) she does not wish to pay any gift taxes; (ii) she wishes her heirs to pay the lowest possible combination of estate taxes and capital gains taxes at her death; (iii) she wishes to maintain investment control of her assets; and (iv) she wishes to maintain her current lifestyle of $500,000 a year before inflation.

Zelda asks Pam to assume that her zero basis assets will grow at 5% a year and generate 3% ordinary taxable income a year. Zelda asks Pam to assume she will live 20 years and that she will not sell the low basis assets during her lifetime. Zelda tells Pam that because of prior gifts she only has $5,340,000 of exemption left. Zelda tells Pam that based on her assumptions that her zero basis assets will be worth over $106,000,00 at her death, which will cause a terrible estate tax problem, or a capital gains tax problem if she uses gifting techniques to remove the low basis assets from her estate to escape estate taxes.

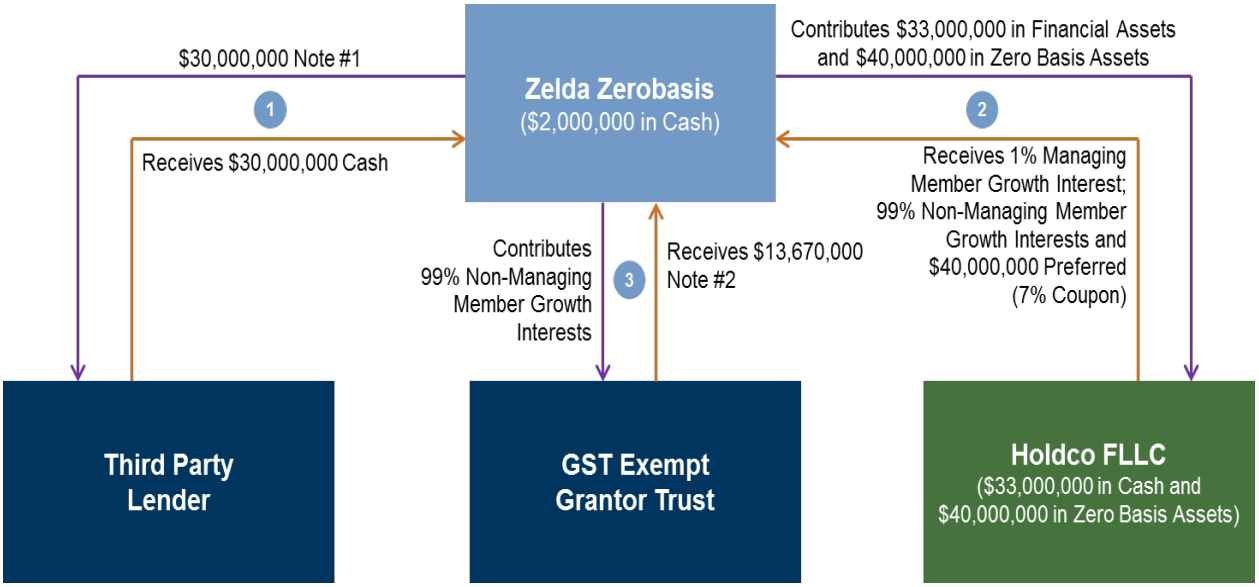
Zelda also asks Pam to assume her cash and near cash investments will have a 7.4% pre-tax rate of return with 0.6% of the return being taxed at ordinary rates, 2.4% of return being tax-free, and 4.4% of the return being taxed at long-term capital gains rates with a 30% turnover.

Pam suggests to Zelda that she create a single member limited liability company with three classes: (i) a "growth" managing member interest; (ii) a "growth" non-managing member interest; and (iii) a preferred non-managing member interest that would pay a coupon of 7% that is cumulative. It is assumed the 7% coupon will be based on the valuation principles of Revenue Ruling 83-120 and will produce a fair market value for the preferred equal to the "par" value of the preferred. The preferred interest will also have a right to $40,000,000 upon liquidation in preference to the growth interests.

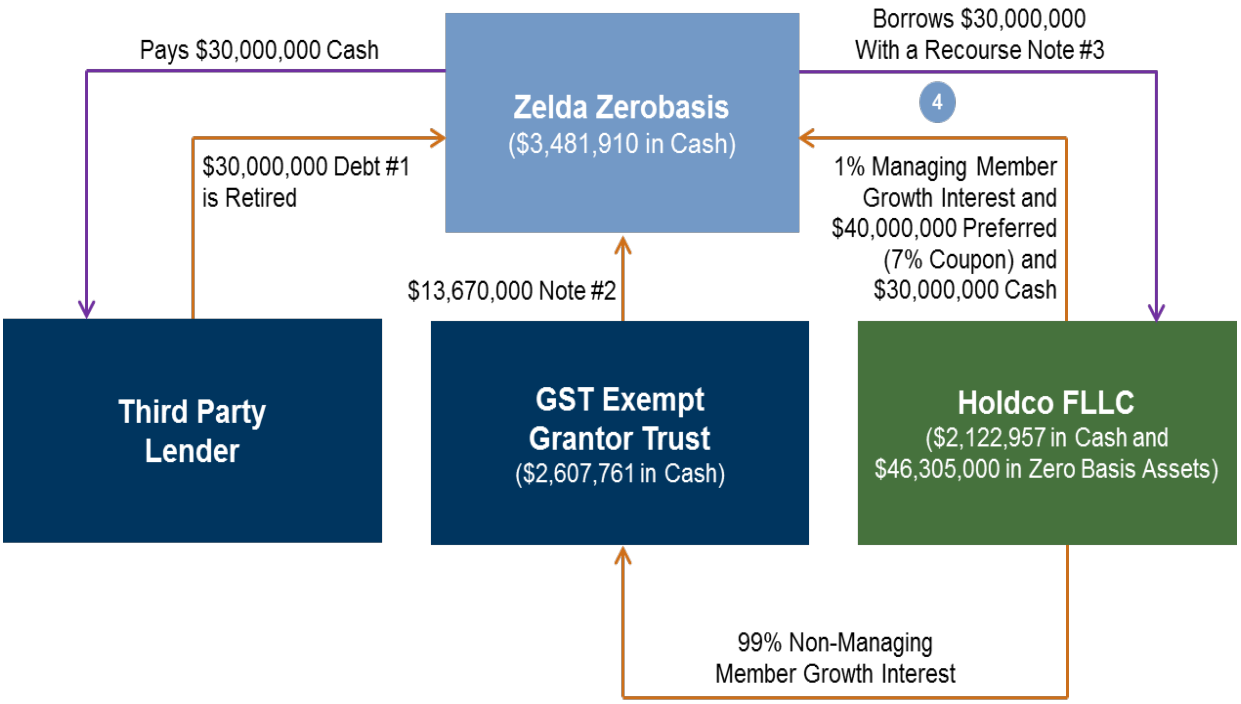
The single member FLLC would terminate on the earlier of her death or 35 years. Pam suggests that Zelda could contribute her low basis assets for the preferred interest. Pam also suggests that Zelda borrow $30,000,000 in cash from a third party lender on a recourse basis and contribute $33,000,000 in cash to the single member FLLC for the growth interests. The diagram below illustrates these transactions.



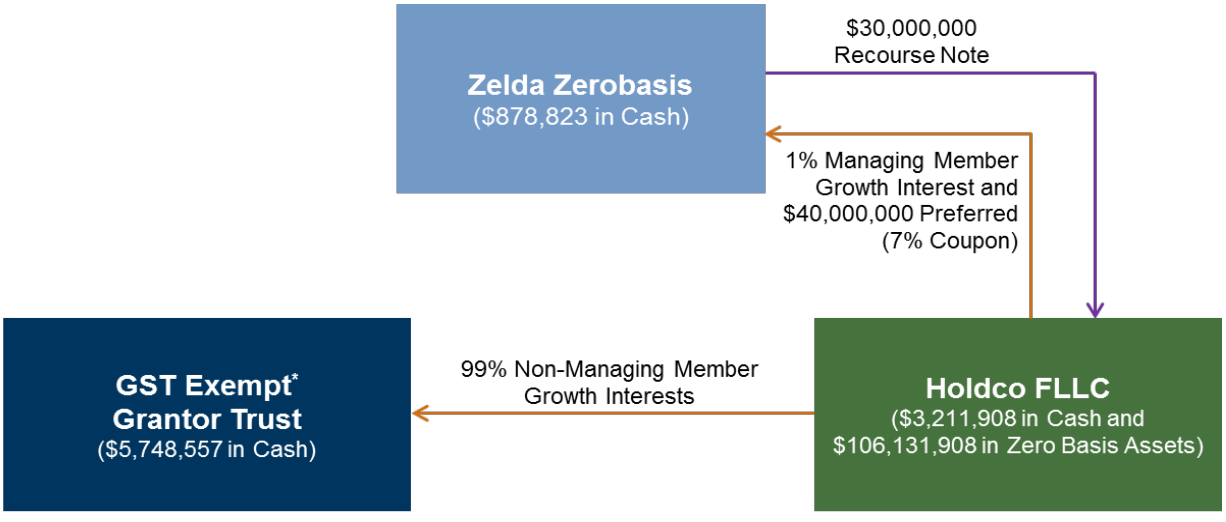
Pam suggests that Zelda could then gift (using her remaining $5,340,000 gift tax exemption) the non-managing member growth interests and sell the remaining non-managing member growth interests to a GST exempt grantor trust in separate independent transactions. Assuming a 40% valuation discount is appropriate because of the liquidation preference and income preference of the retained preferred interest, these transactions could be represented by the following diagram:



After three years Zelda may wish to borrow cash from Holdco, FLLC on a long-term recourse, unsecured basis to pay her recourse loan from the third party lender. (*See* discussion *supra* Section VIII) After the payment of the loan to the third party lender the structure will be as shown below:



The moment before Zelda's death in 20 years the structure under the above assumptions may be as follows (*also see* attached Schedule 22):



*Grantor Trust status removed in year 18.

At Zelda's death the single member FLLC could terminate and her estate would pay the note owed to the single member FLLC. Her estate would receive a step-up in basis for the preferred interest in Holdco. Holdco, FLLC could sell the zero basis assets after an IRC Sec. 754 election is made. The balance in Zelda's estate and the GST exempt trust, after capitals gains taxes, but before estate taxes, would be as follows (*see* attached Schedule 22):

*Grantor Trust status removed in year 18.

2. Income tax and basis enhancing advantages of the technique.

   a. This technique has the same advantage of being able to use third party borrowing by a disregarded entity to achieve basis adjustment in low basis assets.

See discussion *supra* Section VIII.

   b. The net effect of the illustrated technique is that for every $1 of the taxpayer's estate exposed to estate taxes there is a $4 increase in basis of the low basis assets subject to the technique.

In this example the taxpayer has a net $10,000,000 estate ($40,000,000 preferred interest minus a $30,000,000 deductible debt). However, the taxpayer's partnership interest, on the taxpayer's death, will have an outside basis of $40,000,000. If an IRC Sec. 754 election is made, the inside basis of the partnership assets will be increased.

3. Transfer tax advantages of the technique.

   a. The net after income and transfer tax savings to Zelda are projected to be substantial. *See* the table below and attached Schedule 22.

Table 18

	Zerobasis Children (1)	Zerobasis Children & Grandchildren (2)	Consumption (3)	Consumption Investment Opportunity Cost (4)	Opportunity Cost/(Benefit) of Borrowing from 3rd Party Lender (5)	IRS Income Tax (6)	IRS Income Tax Investment Opportunity Costs (7)	Estate Taxes (8)	Total (9)
20-Year Future Values									
No Further Planning: Bequeaths Estate to Family	$44,616,886	$8,530,000	$12,772,329	$13,053,175	$0	$15,575,474	$15,627,875	$29,744,590	$139,920,329
Hypothetical Technique: Bequeaths Remaining Estate to Family	$3,135,638	$82,597,794	$12,772,329	$13,053,175	($11,079,903)	$22,247,774	$15,103,098	$2,090,425	$139,920,329
Present Values (Discounted at 2.5%)									
No Further Planning: Bequeaths Estate to Family	$27,228,389	$5,205,611	$7,794,581	$7,965,974	$0	$9,505,259	$9,537,238	$18,152,259	$85,389,311
Hypothetical Technique: Bequeaths Remaining Estate to Family	$1,913,589	$50,407,034	$7,794,581	$7,965,974	($6,761,743)	$13,577,170	$9,216,982	$1,275,726	$85,389,311

Unlike a traditional gift planning technique, that eliminates estate taxes by removing an asset from the taxpayer's estate, there will be a significant step-up in basis on the death Zelda. Under this example there will be a step-up on the $40,000,000 preferred interest, which before her death had a zero basis. **In other words, for every $1 exposure to estate tax in this technique, under these facts, there is a $4 increase in basis.** Assuming an IRC Sec. 754 election is made that outside basis may be allocated to the assets owned by the partnership.

b. This technique has the same advantages as a SIDGT.

See discussion *supra* Section III.B.

4. Considerations of the technique.

a. This technique has the same considerations as a SIDGT, except this technique may address step-up in basis planning in a more advantageous manner.

See discussion *supra* Section III.C.

b. Care must be taken to comply with the gift tax valuation rules of IRC Sec. 2701.

Among other factors, the preferred interest must be structured (or treated by election and administered) as a "qualified payment right" for purposes of IRC Sec. 2701(c)(3) and Treas. Reg. §25.2701-2(b)(6). *See* discussion *supra* Section XII.B.

c. Third party financing, at least on a temporary basis, may be necessary.

The after-tax interest costs of third party financing may lower the amount accruing to the family. However, in this example, it was assumed the financial assets purchased would produce a higher rate of return than the interest rate cost.

d. This technique has many of the same considerations as a grantor trust has in third party borrowing to achieve basis adjustment in low basis assets.

See discussion *supra* Sections III.C.3 and VIII.

D. Preferred Partnership Freeze That is IRC Sec. 2701 Non-compliant to Solve the Problems Associated With a Disappearing Exemption and a Client Who Needs Cash Flow Using the Intentionally Defective Preferred Interest Partnership or "IDPIP" Technique.

1. What is the IDPIP Technique?

A taxpayer, because of the increased gift tax exemption, may be concerned that he or she cannot use the increased exemption because of the need to access the cash flow from the assets that could be given away. However, if the increased gift tax exemption is not used that taxpayer may be concerned that the increased gift tax exemption may be eliminated in 2025, or earlier, depending upon future elections. A taxpayer, with that profile could retain a preferred interest in a FLP or a FLLC, which uses his new exemption, even though the preferred is subject to estate taxes as if it is retained, and still achieve substantial estate tax savings because the preferred is worth zero for estate tax purposes. Consider the following example:

Example 29: Rachel Reluctant Creates a FLLC and Retains Preferred Interest That Does Not Have Any Value For Gift Tax or Estate Tax Purposes

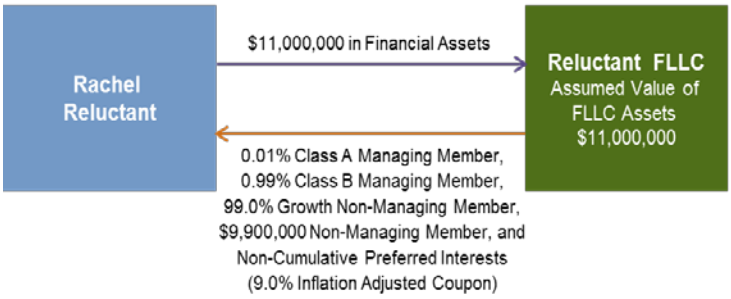
Rachel Reluctant is not married and owns $12,000,000 in financial assets. Rachel has a 15-year life expectancy. The $12,000,000 in assets is projected to grow in value to approximately $16,000,000 in 15 years, after consumption and income taxes. Over that 15-year period, she expects to spend $360,000 a year, inflation adjusted (or about $6,500,000 in future value dollars), on her consumption needs. She expects that her assets will have approximately an annual 7% rate of return, pre-tax. Rachel believes that of that 7% annual return, approximately 3% will be taxed at ordinary income tax rates and 4% at long-term capital gains rates with a 30% turnover. Rachel does not wish to pay any estate or gift taxes on her wealth.

Rachel is aware that the increase in current exemption to $11.18 million may be cut in half in 2026 if she does not use it.

In the past, Rachel has been reluctant to enter into any planning because she would like to have the flexibility to change her mind as to future stewardship of at least part of her assets. Rachel has also been reluctant to enter into planning because she would like the option of retaining most of her cash flow from the investments for her spending needs and any last illness expenses. Rachel would also like to obtain, as much as possible, a step-up in basis on her appreciated assets at her death.

Rachel's current attorney, Fred Freeze, suggests that she contribute $11,000,000 of her assets to a FLLC in consideration for a flexible non-cumulative preferred whose non-cumulative coupon grows with inflation and growth interests. The preferred could have a put right equal to its par value.

This technique is illustrated below:

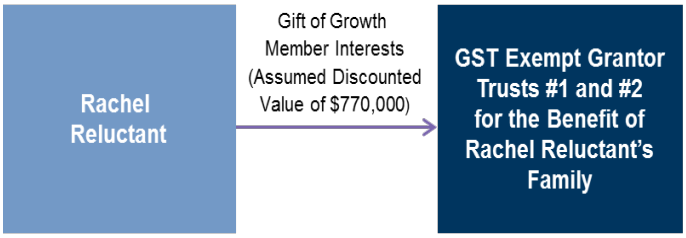


FLP Partner	Ownership %
Rachel Reluctant (or affiliates)	0.01% Class A Managing Member, 0.99% Class B Managing Member, 99.0% Growth Non-Managing Member $9,900,000 Non-Managing Member, and Non-Cumulative Preferred Interests (9% Inflation Adjusted Coupon)

In this example, the beginning non-cumulative preferred interest coupon of $891,000 (9% times $9,900,000) is designed to grow with inflation. There is flexibility because the preferred is non-cumulative. The preferred is also designed to give Rachel the right to put the preferred to the partnership at any time and receive the par value of the preferred from the partnership. If there is not enough net cash flow in the FLLC in any one year to pay all of the preferred coupon, the coupon will only be paid to the extent the net cash flow exists. If Rachel does not withdraw all that she could under her noncumulative preferred coupon rights that will not be considered a gift. *See Snyder v. Comm'r*, 93 TC 529 (1989). If Rachel is in a position to control the investments of the FLLC that investment power alone should not constitute a legal right as described in IRC Secs. 2036 or 2038.

At a later time, in an independent and distinct transaction, Rachel could give 99% "growth" non-managing interests in the FLLC to a generation-skipping exempt grantor trust for the benefit of her family. Due to considerations with respect to retaining entity distribution, amendment and liquidation powers, Rachel could retain the 0.01% Class A managing member interest and transfer the 0.99% Class B managing member interest. The Class A managing member interests would control all entity managing member decisions, including investment management decisions that are not delegated to the Class B managing member interest. The Class B managing member interests would control all distribution, amendment and liquidation decisions. Rachel could give her Class B managing member interest to a grantor trust in which

the initial trustee is an advisor or family member she trusts. Rachel could have the power to replace the trustee of that donee trust with a new trustee, as long as the replacement trustee is not related or subservient. *See* the illustration below:

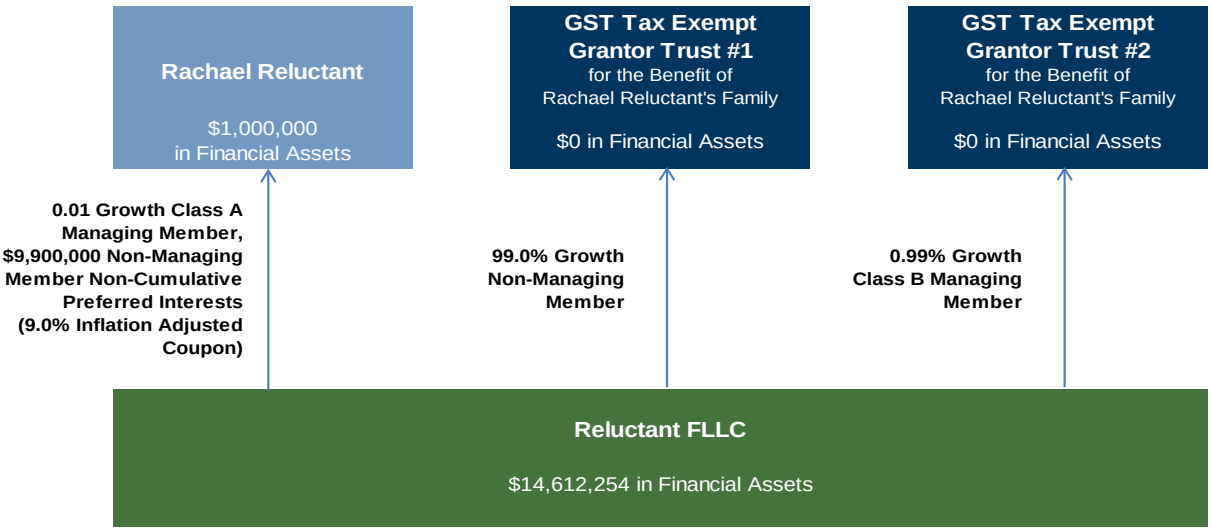


FLP Partner	Ownership %
Rachel Reluctant (or affiliates)	0.01% Class A Managing Member, $9,900,000 Non-Managing Member, and Non-Cumulative Preferred Interests (9% Inflation Adjusted Coupon)
GST Exempt Grantor Trust #1	99.0% Growth Non-Managing Member
GST Exempt Grantor Trust #2	0.99% Class B Managing Member Interest

If the preferred interest is non-cumulative, and does not have any fixed liquidation rights, it will be worth "0" for gift tax purposes under the subtraction method (explained in greater detail below) because of the operation of the valuation rules under IRC Sec. 2701. However, those rules, for gift tax purposes, do not affect the minority and marketability discounts associated with gifts of junior ("growth") interests. Also, the valuation rules under IRC Sec. 2701, do not apply in determining the amount of any generation-skipping gift.

Taking into account the deemed "0" value of the preferred interest, assuming a 30% discount on the growth interest, and other assumed facts of our example, Rachel will be considered to have made a $10,670,000 gift, for gift tax purposes, when she gifts the growth interest ($9,900,000 preferred plus a growth interest valued at $770,000) under the subtraction method for determining the value of the gift under IRC Sec. 2701. *See* IRC Treas. Reg. § 25.2701-3(b). However, the $9,900,000 "extra gift" caused by the gift tax valuation rules will be mitigated by subtracting the amount of that $9,900,000 "extra gift" in calculating the estate taxes at Rachel's death. *See* IRC Treas. Reg. § 25.2701-5(a)(3). The further good news is that mitigation does not affect the calculation of the value of the preferred interest for estate tax purposes, which can lead to basis step up advantages, if an IRC Sec. 754 election is made by the partnership. Rachel will have made a transfer valued at $770,000 for generation-skipping tax purposes when she gifts the growth interest (because the valuation rules of IRC Sec. 2701 do not apply for generation-skipping tax purposes), so only $770,000 of GST exemption is required to create a zero "inclusion ratio" and prevent the application of GST tax to the trust. However, if the preferred interest is transferred to the GST trust at Rachel's death, an allocation of additional GST exemption equal to the value of the preferred interest at death would be required to preserve a GST inclusion ratio of zero, without any reduction for the amount of the prior "extra gift".

In 15 years, at the time of Rachel's death, under the above assumptions, Rachel's balance sheet and the family FLLC balance sheet will be as follows:



Despite the fact that Rachel has available the cash flow from almost all of her assets, and those assets have a value more than double the available transfer tax exemption in 2025, the technique is very effective in avoiding estate and gift taxes. There will be no estate tax, there will no gift tax, and there will be a step up in basis on around $11,000,000 of the assets, if an IRC Sec. 754 election is made by the FLLC on her death. *See* the table below (*see infra* Schedule 23). The same step-up in basis would probably not be available with a note sale to a grantor trust.

Table 19

	Total to All Descendants		Consumption		Income Tax		Estate Taxes (@ 40%)	Total
	Reluctant Children	Reluctant Children and Grandchildren	Direct Cost	Investment Opportunity Cost	Direct Cost	Investment Opportunity Cost		
15-Year Future Values								
No Further Planning: Bequeaths Estate to Family (assumes $7.9mm estate tax exemption available at death)	$4,894,296	$7,900,000	$6,455,494	$4,030,373	$4,050,605	$2,514,747	$3,262,864	$33,108,378
	$12,794,296							
Creation of a FLLC; Gift of Growth Non-Managing Member Interests to a GST Exempt Grantor Trust; Bequeaths Estate to Family; $9.9mm Non-Managing Member Non-Cumulative Preferred Not Taxed in Estate (assumes $12.20mm estate tax exemption equivalent available at death which includes an additional $9.9mm mitigation of preferred)	$8,746,123	$6,866,132	$6,455,494	$4,030,373	$4,495,510	$2,514,747	$0	$33,108,378
	$15,612,254							
Present Value (discounted at 3%)								
No Further Planning: Bequeaths Estate to Family (assumes $7.9mm estate tax exemption available at death)	$3,141,462	$5,070,709	$4,143,536	$2,586,943	$2,599,929	$1,614,120	$2,094,308	$21,251,008
	$8,212,172							
Creation of a FLLC; Gift of Growth Non-Managing Member Interests to a GST Exempt Grantor Trust; Bequeaths Estate to Family; $9.9mm Non-Managing Member Non-Cumulative Preferred Not Taxed in Estate (assumes $12.20mm estate tax exemption equivalent available at death which includes an additional $9.9mm mitigation of preferred)	$5,613,803	$4,407,109	$4,143,536	$2,586,943	$2,885,497	$1,614,120	$0	$21,251,008
	$10,020,912							

2. Advantages of the Technique.

a. Tax advantages of creating a grantor trust and tax advantages similar to a sale to a grantor trust.

Instead of a sale to a grantor trust for a note, this technique illustrates a transfer to a grantor trust using equity interests. That is, the taxpayer retains a preferred interest and his or her interest in the enterprise owned by the grantor trust is frozen. Like interest in a note sale to a grantor trust, the preferred coupon entitles the taxpayer to the first call on the income of the FLP. Unlike the interest rate on a note, which is fixed, the preferred coupon in this example is designed to increase with inflation and it will only be paid if there is enough income in a fiscal year of the enterprise to pay the coupon. *See supra* Section III.B.

b. The near term death of the grantor of a grantor trust generally does not affect the technique like the death of a grantor of a GRAT.

See discussion *supra* Section V.C.

c. The appreciation of the assets of the trust, above the preferred coupon that is paid, will not be taxable in the grantor's estate.

As noted above, this technique has some similarities to a sale to a grantor trust for a note, the difference being that the taxpayer retains a preferred coupon that increases with inflation. *Also* s*ee* discussion *supra* Section III.B.

d. IRC Sec. 2036 avoidance advantage.

See the discussion *supra* Section XII.

e. Flexibility advantages.

Since the preferred coupon is noncumulative, this technique has the advantage of flexibility. If in a particular tax year the enterprise investments do not produce enough cash flow to pay the preferred coupon, the taxpayer's estate does not grow because of the cumulative feature. The fact that the preferred will be worth zero under the subtraction method for gift tax purposes will not hurt the taxpayer, from a transfer tax perspective, if the overall gift of the FLLC or FLP is still under the gift tax exemption. This is because of the mitigation rule in Treasury Regulation Section 25.2701-5(a)(3). Under that mitigation rule, the donor's tentative tax under IRC Sec. 2001(b) will be reduced by the same amount the gift of the enterprise value was increased by operation of IRC Sec. 2701 due to the zero value rule. Furthermore, the zero value rule does not apply for generation-skipping tax purposes.

f. Basis advantages.

The taxpayer's estate will get a step up in basis for the fair market value of the preferred, which can be transported to the assets of the FLLC or FLP under IRC Sec. 754. The Treas. Reg. §24.2701-5(a)(3) mitigation rule affects how the estate tax is calculated, not how the fair market

value of the preferred is determined for estate tax purposes. IRC Sec. 2701 valuation rules for preferred interests only apply for gift tax purposes – they do not apply for estate tax purposes. The "put" right alone in this example would probably mean the preferred is equal "par" for estate tax purposes and IRC Sec. 1014 purposes. Under the facts of this example, the taxpayer's estate will also receive a step up in basis for her assets that are held outside of the FLP. The only assets for which the taxpayer will not receive a step up in basis are those assets owned by the generation-skipping transfer trust before the decedent's death, including the growth interests then owned.

For assets subject to liabilities, which result in a negative basis for those assets, a step up in basis is particularly important. A modification of the technique may be very useful for negative basis assets. Consider upon creation of the FLP a non-disregarded entity (e.g., an FLLC owned 99% by a grantor trust and 1% by the grantor's spouse) could acquire a common interest in exchange for cash. The donor could contribute negative basis assets in exchange for a preferred interest. Liabilities of contributed assets are allocated to the preferred interest holder under the nonrecourse liability allocation rules under IRC Sec. 704. If the preferred interest is includable in the donor's estate "step up" in basis is available for all of the negative capital owned by the FLP.

g. The capital gains considerations that may exist for existing note receivables and/or payables with the sale to a grantor trust technique does not exist at death with this technique.

Unlike a situation with respect to note receivables and payables with the sale to a grantor trust technique where there may be income tax consequences on the death of the beneficiary, there will not be any income tax consequences on the death of the owner of the preferred interest and, as noted above, there will be a step up in basis of the preferred and the partnership assets associated with the preferred at the taxpayer's death. *See* discussion *supra* Section III.C.3.

h. The technique could work in much larger situations through the use of debt.

Assume the same facts as this example, except Rachel has $90,000,000 more in assets. Rachel could loan or sell $90,000,000 in assets for a note to the FLLC and there would not be any additional gift tax under the gift tax valuation rules of IRC Sec. 2701. This is because of the debt exception to the valuation rules of IRC Sec. 2701. *See* IRC Sec. 2701(a)(1).

3. Considerations of the Technique.

a. There needs to be enough substantive equity in the growth interest in the entity.

Under the gift tax valuation rules of IRC Sec. 2701 the common interest will be deemed to have at least 10% of the value of entity for gift tax purposes. Furthermore, it is difficult to find comparables in determining what the rate of the preferred coupon should be, unless there is substantive equity in the common interest.

b. The IRS could be successful in applying the step transaction doctrine to the technique.

c. If the assets of the entity decrease in value, the gift tax exemption equivalent may not be recoverable.

d. The IRS may contest the valuation of the growth interests that are donated to the grantor trust.

This consideration may have a solution if defined allocation transfers and/or defined dollar transfers are used. *See supra* Section IV.

See discussion *supra* Section III.C.5 for methods to mitigate any such contest.

XV. GIFTING AND SELLING LOW BASIS ASSETS TO A GRANTOR TRUST WHERE AN OLDER GENERATION IS A BENEFICIARY AND IS SUBJECT TO AN OLDER GENERATION'S GENERAL POWER OF APPOINTMENT AND ESTATE TAXES ("UPIDGT").

A. The UPIDGT technique.[204]

A taxpayer could gift cash and then later sell some of his low basis assets (for adequate and full consideration) to a grantor trust in independent transactions. The beneficiaries of the trust could be the taxpayer's descendants and an older generation beneficiary, such as a parent. The older generation beneficiary could be given a general power of appointment that will be structured to include those trust assets in his or her estate. If the grantor first gifts high basis cash to the trust, IRC Sec. 1014(e) should not apply to that gift of cash because it is not a low basis asset. The sale of low basis assets could be for a recourse, unsecured note in which both the trustee and the older generation beneficiary are personally liable. A sale price that is equal to the fair market value of the low basis assets, perhaps pursuant to a defined value allocation assignment, should also circumvent IRC Sec. 1014(e). For a discussion of defined value assignments *see supra* Section III.C.5. If the sale price is equal to the value of the low basis asset there is not a gift and IRC Sec. 1014(e) does not apply, even if the older generation beneficiary dies within one year. For a discussion of IRC Sec. 1014(e), *see supra* Section II.A.1.a.(4).(v).

If the older generation beneficiary's estate is small, that general power of appointment may not result in any estate taxes being assessed against his estate. The general power of appointment could be designed so that it may not be exercised unless approved by a non-adverse party such as an independent trustee. Consider the following example:

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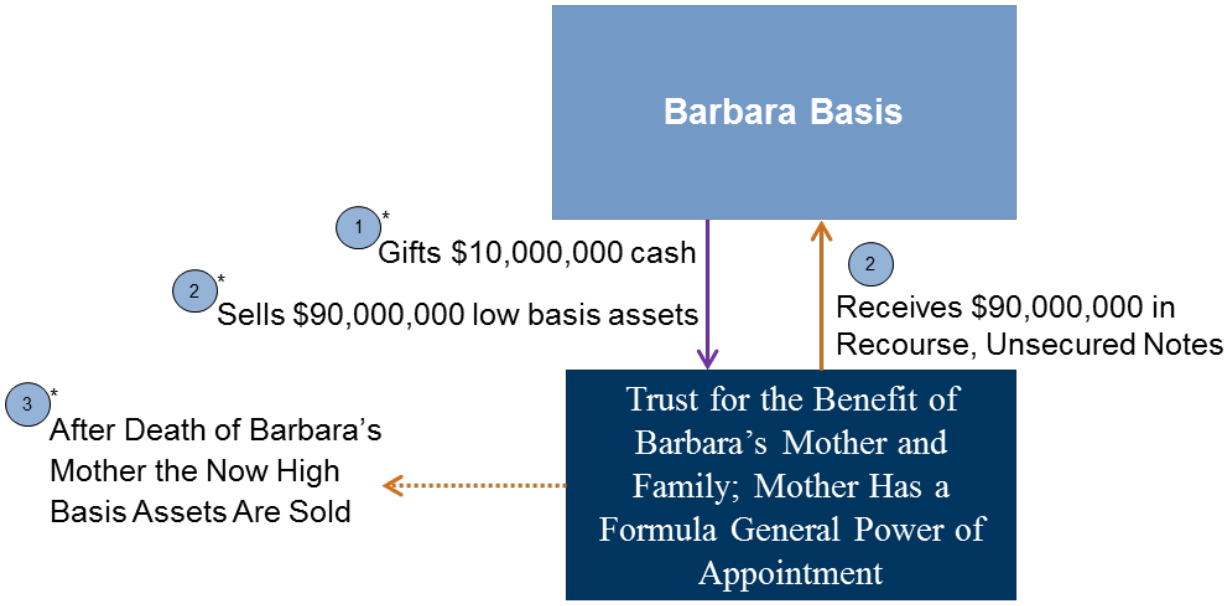
[204] *See* Mickey R. Davis and Melissa J. Willms' discussion of the accidently perfect grantor trust, *Trust and Estate Planning in a High Exemption World and the 3.8% "Medicare" Tax: What Estate and Trust Professionals Need to Know*, 61st Annual Tax Conference – Estate Planning Workshop, 31-33 (December 6, 2013).

Example 30: Barbara Basis Creates a UPIDGT for the Benefit of Her Mother, Gmom Basis, and Her Family and Makes Certain Sales to That Trust

In separate and distinct transaction ("Transaction 1) Barbara contributes $1,000,000 in cash to a trust that is a grantor trust for income tax purposes. Barbara's mother, Gmom Basis, is the initial beneficiary and is given a general power of appointment over the trust. Barbara, at a later time (Transaction 2) sells $9,000,000 in low basis property to that trust, pursuant to a defined value allocation formula for a recourse note in which both the trust and Gmom Basis are personally liable. The recourse note is unsecured. After Gmom's death (Transaction 3), the trustee of the trust sells the now high basis assets and reinvests the proceeds in new assets.

The technique is illustrated below:



* These transactions need to be separate, distinct and independent.

B. Income Tax and Basis Enhancing Advantages of the UPIDGT Technique.

1. This technique has the same advantages as a SIDGT.

See discussion *supra* Section III.B.

2. The assets of the trust will receive a step-up in basis on the older generation beneficiary's death equal to the fair market value of the assets, if net value rule of treas. reg. §2053-7 does not apply (see discussion *infra* Section XV.D.5).

The non-depreciable trust assets could be sold after the older generation beneficiary's death and reinvested without capital gains tax consequences.

C. Transfer Tax Advantages of the UPIDGT Technique.

1. The assets of the trust may be generation-skipping tax protected.

2. The older generation beneficiary may not have to pay estate taxes because of her general power of appointment, if her then available unified credit exceeds the net value of the trust.

3. Also consider the income and transfer tax advantages that could accrue if the older generation exercises her testamentary general power of appointment in favor of a BDOT (see the discussion of BDOTs *supra* Section IX.C) in which the younger generation creator of the UPIDGT is the initial beneficiary.

That exercise of the general power of appointment must be independent and there must not be any prior understanding that the older generation would so exercise that power.

A BDOT could become, under those circumstances, an ideal trust for the younger generation (Barbara) to sell her individual assets to the BDOT, or the younger generation could use the LAIDGT technique with that BDOT.

D. Considerations of the UPIDGT Technique.

1. The grantor of the trust will still have a low basis in his or her note upon the death of the older generation beneficiary.

Even though the assets of the trust will receive a step-up in basis on the older generation beneficiary's death, the grantor's note does not. Under the logic of Revenue Ruling 85-13, the note does not exist as long as the grantor status of the trust is maintained. After the older generation beneficiary's death the note may be satisfied, without tax consequences, with the now higher basis assets owned by the trust.

2. The older generation beneficiary could exercise his or her general power of appointment in an unanticipated way.

That possibility could perhaps be mitigated by requiring that an independent, non-adverse trustee approve any exercise of a general power of appointment before it is effective. This veto power seems consistent with IRC Sec. 2041(b)(1)(c)(ii), which says the power is a general power unless the veto right is held by someone "having a substantial interest in the property, subject to the power, which is adverse to exercise of the power in favor of the decedent."

3. Many of the same considerations for the use of a grantor trust and a sale to a grantor trust would also be present for this technique. *See* discussion *supra* Section III.C.

In order to remove the uncertainty of the consideration discussed *supra* Section III.C.3, the grantor trust could pay the note with cash or assets in kind before the grantor's death. Another strategy is for either the grantor or the trust to use third party lending. *See* discussion *supra* Section VIII.

4. The effect of IRC Sec. 1014(e) must be considered, if cash is not given and low basis assets are used to capitalize the trust.

See discussion *supra* Section II.A.1.a.(4).(v).

If the donor is a beneficiary of a new trust created after the death of the donee by the donee's exercise of a power of appointment, there may not be a step-up of the trust assets with respect to the donor's actuarial interest in the trust. If the donor's interest is purely discretionary in a new trust created by the older generation's exercise, IRC Sec. 1014(e) may not apply even if the older generation beneficiary dies within one year of the donor's creation of the grantor trust. Another key exception to the application of IRC Sec. 1014(e) is whether the decedent acquired any part of the included low basis assets by "gift". If the decedent acquired the asset by sale, or by part sale-part gift, it would appear that the percentage of the asset acquired by sale should not be subject to IRC Sec. 1014(e). If the donor does not have a high basis asset, or cash, to initially capitalize the trust, the donor may wish to borrow cash to initially capitalize the trust. *See* discussion *supra* Section VIII.

5. The effect of Treas. Reg. §20.2053-7 needs to be considered.

Treas. Reg. §20.2053-7 provides:

> A deduction is allowed from a decedent's gross estate of the full unpaid amount of a mortgage upon, or of any other indebtedness in respect of, any property of the gross estate, including interest which had accrued thereon to the date of death, provided the value of the property, undiminished by the amount of the mortgage or indebtedness, is included in the value of the gross estate. **If the decedent's estate is liable** for the amount of the mortgage or indebtedness, **the full value of the property** subject to the mortgage or indebtedness **must be included** as part of the value of the gross estate; the amount of the mortgage or indebtedness being in such case allowed as a deduction. **But if the decedent's estate is not so liable, only the value of the equity of redemption** (or the value of the property, less the mortgage or indebtedness) **need** be returned as part of the value of the gross estate. In no case may the deduction on account of the mortgage or indebtedness exceed the liability therefor contracted bona fide and for an adequate and full consideration in money or money's worth. (Emphasis added.)

In the example, the debt is unsecured and the debtor has personal liability to the lender. As a consequence, the full value of the gross assets could be included in the value of the decedent's estate and the liability will be separately deducted.

What if the debt is secured and the liability is non-recourse? What is the meaning of the word "need" as it is used in the regulation?

Could the IRS may make it clear, if an asset is included in a decedent's estate, and is subject to non-recourse debt, only the net value of the asset is to be reported in the decedent's estate (gross asset value minus the debt) and there will only be a partial step-up?

Fortunately, Prop. Reg. §1.1014-10(a)(2) provides: "The existence of recourse or non-recourse debt secured by property at the time of the decedent's death does not affect the property's basis, whether the gross value of the property and the outstanding debt are reported separately on the estate tax return or the net value of the property is reported."

6. Is grantor trust status lost for the original grantor when the older generation beneficiary dies and the trust assets are included in the beneficiary's estate?

Treas. Reg. §1.671-2(e)(6) contains an example that would seem to indicate that the grantor trust status would not change, if the older generation does not exercise his or her general power of appointment:

> Example 8. G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

It should be noted that this consideration should not exist, if the older generation beneficiary exercises her general power of appointment in favor of a BDOT in which the younger generation UPIDGT creator is the initial BDOT beneficiary (*see* the discussion *supra* Section XV.C.3), because the BDOT will be a grantor trust to that younger generation creator.

7. IRC Sec. 1014(b)(9) needs to be considered for property that has depreciated.

IRC Sec. 1014(b)(9) (but none of the other IRC 1014 sections) limits the basis adjustment for depreciation taken by a taxpayer other than the decedent. If the trust remains a grantor trust as to the younger generation grantor who originally took the depreciation deduction, after the death of the older generation holder of the general power of appointment, then the amount of the basis adjustment might be reduced by the amount of the depreciation deductions allowed to the younger generation grantor prior to the older generation member's death. See Treas. Reg. §1.1014-6.

Under certain circumstances, if this technique is to be used with depreciable property, it may make sense to use valuation discount techniques to sell a depreciable asset to a non-grantor trust (in order to lower the tax consequences of the sale to the non-grantor trust). For instance, a depreciable asset held in a partnership that can be discounted for valuation purposes, could be sold to a non-grantor trust under which the older generation has a power of appointment. At a later time, before the death of the older generation general power holder, in a transaction that is independent, the depreciated asset could be distributed from the partnership, or the partnership could terminate. IRC Sec. 1014(b)(4) should apply to the depreciated real estate under those circumstances and the depreciated asset should receive a step-up in basis.

Consideration could also be given to using one of the mixing bowl techniques discussed *supra* Section XIV.B as a work around of the effect of IRC Sec. 1014(b)(9) on depreciable assets.

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