Private Wealth Management

Some of the Best Synergistic Family Limited Partnership and Family Limited Liability Company Estate Planning Ideas We See Out There

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The Primary Importance of Goals-Based Planning for the Successful Succession of the Family Wealth Irrespective of the Status of the Tax Law (Pages 1 – 3 of the Paper)

- The importance of first determining a client's goals that determine the estate plan's essential strategies.
    - 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."
    - 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.
    - A danger in tax driven wealth preservation planning is its subtle power to enable money (and its conservation) to become the defining objective.
- Four personal rules for determining a client's goals and concerns with respect to the family's capital: (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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Estate Plans Developed Around the Stewardship of the Family Wealth

- It is enlightening to contrast conventional *tax driven wealth preservation plans* with plans which have been formulated for owners 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.
- 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.

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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

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The Desire for Flexibility for Many Clients in Making Gifts in 2012 (Page 4 of the Paper)

- For many clients, taking advantage of the above gift planning opportunity produces concerns about meeting future consumption needs and concerns about maintaining flexibility as to future stewardship goals.
- Given the calamity of economic events in 2000, 2001, 2008 and early 2009, many clients legitimately worry about their future consumption needs and how those needs may be affected by large gifts.
- Additionally, all patriarchs and matriarchs have seen family situations that could not be anticipated, which can lead to "donor's remorse" about significant gifts:
  - What if a client changes his or her mind about the stewardship abilities of a child or grandchild?
  - For instance, what if a patriarch or matriarch currently feels that leaving a family member more than $5,000,000 would kill that family member's initiative? However, that patriarch or matriarch concedes that if that child develops leadership characteristics and financial stewardship in the future, the amount of wealth under the control of that child should increase.
- It is clear that taking advantage of existing exemption equivalents before 2013, and packing assets into a vehicle that will not be subject to future estate taxes or generation-skipping taxes, can be a very productive plan; not only for saving transfer taxes, but also for creditor protection purposes for the family.
- The question is what vehicles exist to transfer current wealth that will also provide the client with the flexibility to supplement the client's consumption needs and/or to give the client flexibility to change the characteristics of his or her stewardship goals?
- Unless there is a satisfactory answer to those goals and concerns, many clients will not avail themselves of the current generous (and perhaps temporary) gift planning opportunities.

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A Desire or Goal for Many Clients to Achieve Maximum Tax Subsidization for Charitable Gifts in the New Tax Environment (See Page 5 of the Paper)

- Many clients find that their gifts to their favorite charitable causes can only be partially deducted for income tax purposes and cannot be deducted at all for purposes of determining the new health care tax, which affects the after tax cost of the charitable gift.
- One of the purposes of this paper is to discuss some of our favorite planning ideas that ameliorate those concerns.

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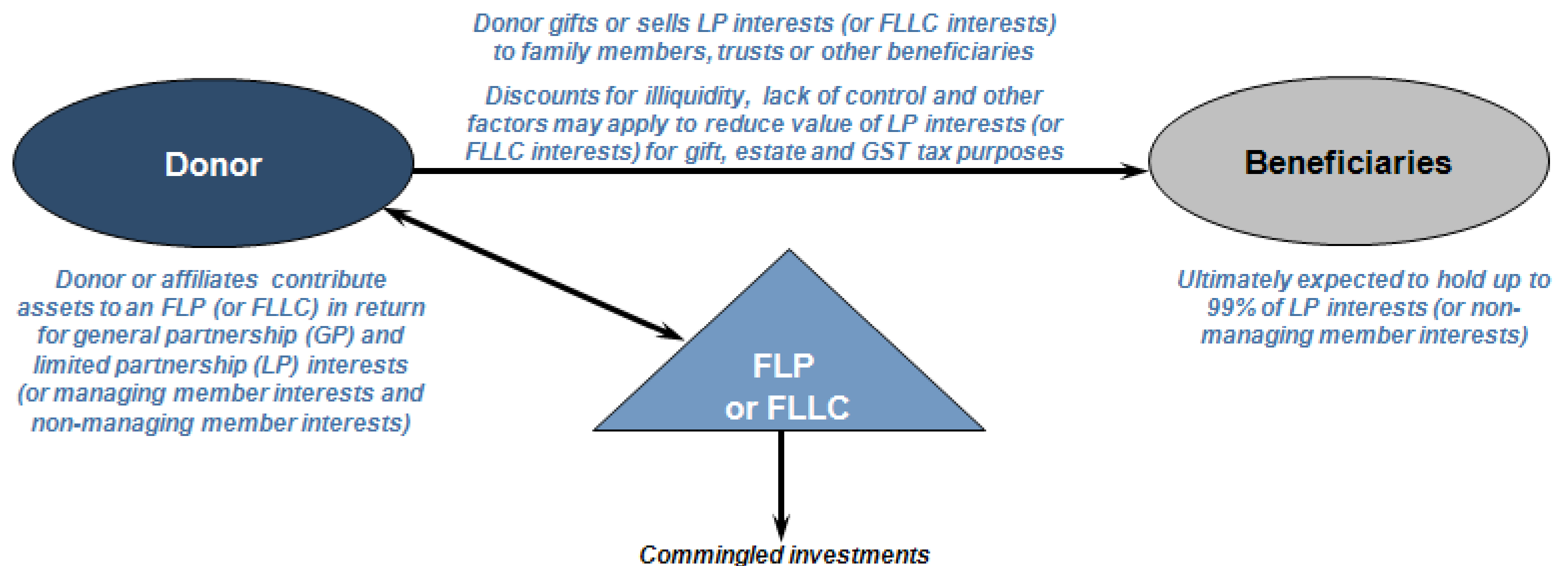
- A transferor could contribute the transferor's assets to a limited partnership and transfer the limited partnership interests to a donee as illustrated below:



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Best Ideas for Allowing a Client to Be in Control of a Family Limited Partnership in the Context of Sec. 2036(a)(2) – Rev. Rul. 73-143, 95-58 and 81-15

- In the *Strangi* case, some commentators believe Judge Cohen's reliance on *O'Malley* is misplaced.
- Sell the partnership interests for full consideration.
- Use the same fiduciary constraints in the partnership as *Byrum*.
- Follow Rev. Rul. 73-143; See sample language (pages 16 to 17 of the paper).
- Follow Rev. Rul. 95-58.
- Follow Rev. Rul. 81-15.

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Conventional Wisdom:

- "For the passive trustee investor, there does not exist any substantive non-tax investment reason to invest in a family limited partnership;" or
- You cannot allocate capital gains taxable income to the income beneficiary of an income only trust."

This "conventional wisdom," under the circumstances discussed below, is incorrect.

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Example 1: Client Wishes to Create Several Trusts For the Benefit of Family Members and Follow Modern Portfolio Theory

Marvin and Maggie Modern wish to give $300,000 to separate trusts for each of their grandchildren. Marvin and Maggie understand modern portfolio theory and the importance of diversification. They want the grandchildren's trusts to invest for the greatest risk-adjusted return and are concerned that the trusts will not be large enough to meet SEC limitations on who may invest in certain alternative asset classes.

In addition to current gift planning, Marvin and Maggie want to provide a qualified terminal interest marital deduction trust ("QTIP") for the surviving spouse under their estate plans. Many of their personal alternative asset investments are held in private equity partnerships now. Marvin and Maggie worry that these investments could cause income tax fairness issues for the QTIP trust – that is, they worry that the surviving spouse, as income beneficiary, may bear a disproportionate amount of income tax liability on the alternative investments - but still feel strongly that the QTIP trust should have exposure to alternative asset classes.

Marvin and Maggie ask their attorney, Pam Planner, how to structure their investment portfolio so the trustees for their grandchildren's individual trusts and the survivor's QTIP trust can invest in the broad array of asset classes necessary to maximize risk-adjusted return under modern portfolio theory.

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- The first investment reason certain trusts are benefited by the creation of family limited partnerships: closely held family limited partnerships may facilitate a trust holding alternative investments and the trust's ability to follow modern portfolio theory.
  - Certain exceptions to the registration requirements under the Securities Exchange Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940 are important to many issuers of alternative investments (e.g., investments such as oil and gas, real estate and other private equity investment funds).
  - It is important that those alternative investment funds be held by "accredited investors" and/or "qualified purchasers".
  - If the Moderns first create a family limited partnership, and then give family limited partnership interests to the trusts for the grandchildren, then the accredited investor and qualified purchaser exceptions may apply. In that manner the trust investments would follow modern portfolio theory.

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Best Investment Planning Idea – Or Why Investment Professionals Love Limited Liability Companies and/or Limited Partnerships (Continued)

- The second investment reason certain trusts are benefited by the creation of family limited partnerships: closely held family limited partnerships facilitate income only (so-called simple) trusts to be fully diversified, as modern portfolio theory seems to require.
  - Closely held family limited partnerships could be a tool to manage distribution fairness issues for income only trusts associated with distributions (or lack of distributions) from alternative investments that could be superior to using a unitrust conversion.
    - Unitrust conversion does not help because of valuation issues with hedge funds and private equity investments.
    - Distributions of private equity and fund investment units cannot be made because of securities concerns.
    - If other assets are distributed it could potentially distort the overall asset allocation.
  - Closely held family limited partnerships could be a tool to manage income tax fairness issues associated with alternative investments for income only trusts.
    - One cash distribution could be made from a family limited partnership to an income only trust and designated as trust accounting income.
    - A second cash distribution could be made from a family limited partnership to an income only trust and designated as corpus to pay trust income taxes.

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- The third investment reason certain trusts are benefits by family limited partnerships: the closely held family limited partnership has the management capacity to carry out the partnership's capital gains income to the income only beneficiary for income tax purposes.
  - Under UPIA Section 401, a distribution of cash from an entity to a trust may be deemed to have carried out capital gain income as trust accounting income, if a trustee does not have distribution control over a family limited partnership.
  - A trustee can only allocate receipts from the entity between income and principal according to the trust agreement or UPIA Section 401.

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Other Non-Transfer Tax Reasons Why Families Form Family Limited Partnerships or Family Limited Liability Companies (Pages 46 – 50 of the Paper)

- A taxpayer, by using the partnership vehicle, has the ability to transfer capital without killing the transferee's productivity and initiative, because the taxpayer may have some indirect control over distributions, which may not be possible with the trust vehicle.
- The partnership vehicle simplifies annual giving for private equity investments.
- The partnership vehicle facilitates assets that are important to be kept in the family.
- The partnership vehicle provides some protection against a taxpayer's future unforeseeable creditors, which cannot be provided to that taxpayer under most states law by using trusts.
- The partnership vehicle provides greater protection of gifted assets against failed marriages.
- Unlike irrevocable, non-amendable trust agreements, partnership agreements are comparatively flexible.

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Other Non-Transfer Tax Reasons Why Families Form Family Limited Partnerships or Family Limited Liability Companies (Continued)

- Business Judgment Rule of Partnership Law offers greater flexibility in investment management than trust law.
- Partnership agreements could be drafted to mandate arbitration of family disputes and circumvent court litigation, which is generally not possible under most state laws with respect to trusts.
- Partnership agreements could be drafted to mandate the “English” rule for disputes (loser pays); that is generally not possible under most state laws with respect too trusts.
- Partnership arrangements facilitate and institutionalize family communication and education on financial matters.
- Partnerships eliminate or lower out-of-state probate costs for real estate investments.

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Other Non-Transfer Tax Reasons Why Families Form Family Limited Partnerships or Family Limited Liability Companies (Continued)

- A partnership is advantageous compared to a "C" corporation because it has one level of income tax and is advantageous compared to an "S" corporation because it allows a greater variety of ownership structures.
- A partnership is advantageous compared to a corporate structure because in many jurisdictions there is no franchise tax or intangibles tax to pay with the use of partnerships.

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Conventional Wisdom:

- "Do not engage in family limited partnership planning unless it can be demonstrated that the partnership uniquely solves a substantive non-tax problem;" or
- "Discounting a client's assets is a much better estate planning tool than grantor trusts or freezing a client's estate."

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Example 2: The Sweet Deal

Cal Client is in his office when Dan Deal knocks on his door and tells Cal that he has “a heck of a deal for him.” Dan states that he would like to sell most of his assets to Cal for 65¢ on the dollar. Cal tells Dan that he likes the price, but he does not want to buy any of the assets for cash. Cal wonders if Dan would still be willing to sell his assets for 65¢ on the dollar, if it was all for a seller financed note from Cal. Dan tells Cal that because he likes him so much he will be happy to accept a note from Cal. Cal then informs Dan that while he likes the 65¢ on the dollar, he likes the fact that he can buy all the assets for a seller financed note, he does not like to pay much interest on the note and wonders if Dan will still offer that deal if the interest rates are comparable to US Treasury interest rates. Again, Dan tells Cal that because he likes him so much he will be happy to do that deal. Cal then informs Dan that while he likes the price of 65¢ on the dollar, and he also likes the fact that he can purchase the assets for a seller financed note at US Treasury interest rates, he will only buy the assets if he will have no personal liability on the note (i.e., the note will be non-recourse). Dan, once again agrees to Cal demands. An increasingly impatient Dan asks Cal if there are any other deal points. Cal says there is just one more. Cal tells Dan that he does not like paying income taxes. Cal will only do the deal if Dan will agree to pay all of the income taxes associated with the assets he is purchasing from Dan. Dan agrees.

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Example 3: Lacy Lucky Sells Her Partnership Interest During Her Lifetime

Lacy Lucky lives in the great state of Nirvana. In the state of Nirvana, plaintiff's lawyers have been banned. In this enlightened state, wealthier spouses always receive all of the marital assets, if there is a failed marriage. Because this state is so enlightened, the SEC is very impressed and has waived its qualified purchaser and accredited investor rules with respect to trusts created under this state's laws. Because of all of these reasons (and because all children in this state are born with above average intelligence), Lacy Lucky is worried that a substantive non-tax reason may not exist for the creation of her family limited partnership. After the creation of the partnership, Lacy will own a 1% general partnership interest and a 98% limited partnership interest. Lacy asks her attorney, Tom Taxadvisor, what she could do to circumvent the application of I.R.C. Section 2036(a)(1) other than steering clear of behavior that might constitute an implied agreement to use the partnership asset income?

- Tom may advise Lacy to sell all of her limited partnership interest for adequate and full consideration.
- Even if the sale is not for adequate and full consideration (e.g. part sale, part gift or all a gift), if Lacy lives longer than three years after the transfer, then I.R.C. Section 2036(a)(1) should not apply to the resulting note (assuming the note is a note for state law property purposes) and/or cash she receives from that sale.

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One of the Best Family Limited Partnership or Family Limited Liability Company Planning Ideas – Sell It (Continued)

- If a sale of a partnership interest occurs during a client's lifetime the gift tax equivalent of IRC Section 2036 may not exist.
- The valuation principles of Revenue Ruling 93-12 apply to lifetime transfers, but they do not apply to transfers at death.
- Growth of the underlying assets of the partnership, if a transfer occurs during the lifetime of a taxpayer, will not be subject to estate tax.
- A future Congress could change the current law with respect to valuation discounts associated with family limited partnerships.
- The taxpayer may have the ability to indirectly access all of the partnership distributable cash flow for consumption needs.
- Generally, the sale of a family limited partnership interest to a trust, is a flexible arrangement that can be modified to changed circumstances.
- The sale of a limited partnership interest for a note facilitates testamentary charitable planning, because the note is a more attractive asset for a charity to receive than family limited partnerships interests.
- There is a significant transfer tax advantage for the taxpayer who transfers his partnership interests during his lifetime to a grantor trust in exchange for a note.

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Example 4: Mimi Minimum Wonders What Additional Transfer Tax Benefit Accrues From a Partnership Valuation Discount Over Her Life Expectancy

Mimi Minimum is a very healthy 50 year old female. Both of her parents are still alive and she has only recently buried her grandparents. Her doctor assures her that she easily has a 30 year life expectancy. Mimi likes the relative simplicity of making a $2,000,000 gift of some of her highly appreciated stock to fund a grantor trust and then selling her highly appreciated stock worth $18,000,000 to that grantor trust for a low interest note after the sale for the note is completed, the grantor trust would then sell all $20,000,000 of its stock ("Technique One" below). Mimi asks her estate planner, Les Rates what is gained by transferring a family limited partnership (which holds $18,000,000 of her stock) to a grantor trust from a transfer tax standpoint, assuming she does live a 30 year period ("Technique Two" below). Mimi is concerned about the costs of creating a family limited partnership (legal costs, accounting costs, administrative costs and valuation expert costs). Mimi tells Les Rates to assume that she will earn 8% pretax return with respect to the proceeds of the sale of the appreciated stock (with 2% being taxed at ordinary income rates and 6% being taxed at capital gains rates with a 30% turnover) and that her consumption needs will be $350,000 a year before inflation. What does Les Rates' analysis demonstrate?

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Technique	Minimum Family	Consumption– Direct Cost	Consumption– Investment Opportunity Cost	IRS– Income Tax	IRS– Investment Opportunity Cost	IRS– Estate Tax (at 45%)	Total
No Further Planning; Bequeaths Estate To Family (Without Discount)	$38,798,412	$16,651,395	$36,796,365	$19,551,445	$57,711,366	$31,744,155	$201,253,138
No Further Planning; Bequeaths Estate To Family (With Discount)	$49,908,866	$16,651,395	$36,796,365	$19,551,445	$57,711,366	$20,633,701	$201,253,138
Technique #1: Hypothetical Integrated Income and Estate Tax Plan With a Gift/Sale to a GST; Bequeaths Estate To Family	$68,269,192	$16,651,395	$36,796,365	$21,308,079	$57,711,366	$516,740	$201,253,138
Technique #2: Hypothetical Integrated Income and Estate Tax Plan With a Partnership and With a Gift/Sale to a GST; Bequeaths Estate To Family	$68,399,886	$16,651,395	$36,796,365	$21,796,365	$57,711,366	$298,954	$201,253,138

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Summary of Results For $20 Million of Asset With "0" Basis Growing at 8% Per Year (Pre-Tax) – No Further Planning vs. Two Hypothetical Integrated Income and Estate Tax Plans; 10 Year Future Values; Post-Death Scenarios (assuming client dies in 10 years)

Technique	Minimum Family	Consumption – Direct Cost	Consumption – Investment Opportunity Cost	IRS – Income Tax	IRS – Investment Opportunity Cost	IRS – Estate Tax (at 45%)	Total
No Further Planning; Bequeaths Estate To Family (Without Discount)	$14,857,342	$4,012,358	$1,692,703	$6,076,989	$4,383,101	$12,156,007	$43,178,500
No Further Planning; Bequeaths Estate To Family (With Discount)	$19,111,945	$4,012,358	$1,692,703	$6,076,989	$4,383,101	$7,901,405	$43,178,500
Technique #1: Hypothetical Integrated Income and Estate Tax Plan With a Gift/Sale to a GST; Bequeaths Estate To Family	$20,869,217	$4,012,358	$1,692,703	$6,780,213	$4,383,101	$5,440,909	$43,178,500
Technique #2: Hypothetical Integrated Income and Estate Tax Plan With a Partnership and With a Gift/Sale to a GST; Bequeaths Estate To Family	$23,931,861	$4,012,358	$1,692,703	$6,635,610	$4,383,101	$2,522,868	$43,178,500

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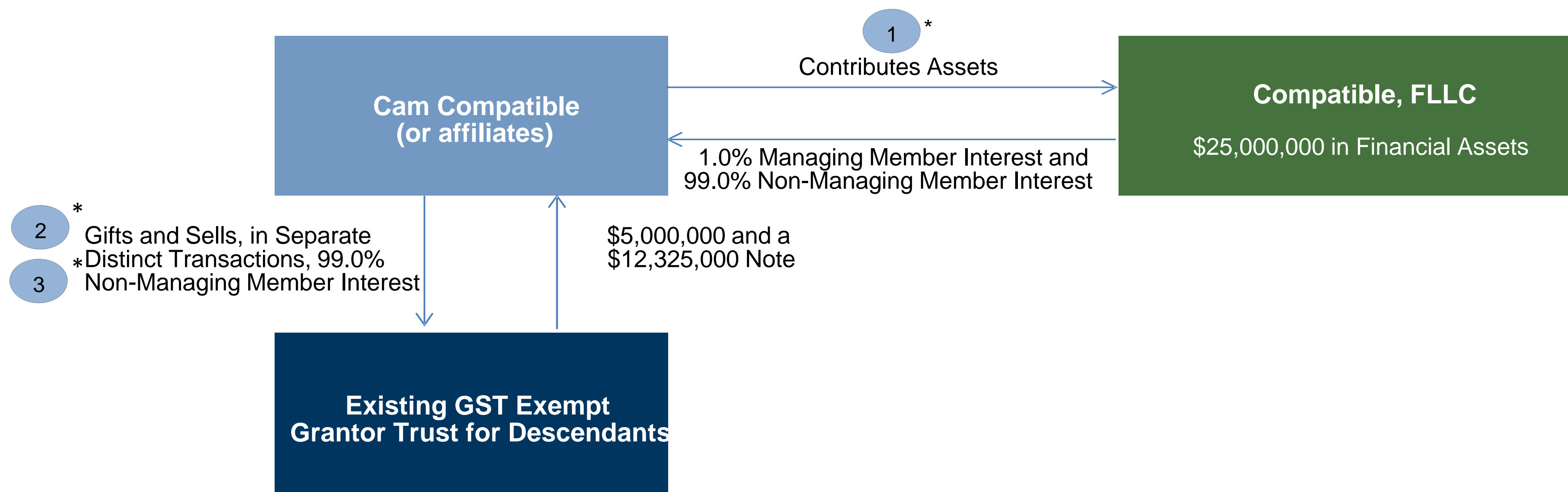
Example 5: Creates a Grantor Trust for the Benefit of His Spouse and Family and Makes Certain Sales to That Trust

Cam Compatible owns $32,000,000 in financial assets. Cam and affiliates contribute $25,000,000 to a FLP or a FLLC ("1"). In a separate and distinct transaction ("2") Cam contributes $5,000,000 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 ("3"), sells his non-managing member interests to that trust, pursuant to a defined value allocation formula. Assuming a 30% valuation discount, the technique ("Hypothetical Technique 1a") is illustrated below:



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

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Advantages of the Technique

- Tax advantages of creating a grantor trust and a sale to a grantor trust.
- The near term death of the grantor of a grantor trust generally does affect the technique like the death of a grantor of a GRAT.
- The appreciation of the assets of the trust above the interest of the note used in any sale to a grantor trust for the grantor's spouse will not be taxable in the grantor/seller's estate.
- Flexibility advantages of selling to a grantor trust, naming the grantor's spouse as a beneficiary and giving a grantor's spouse a special power of appointment.

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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 retained note 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 nor 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.

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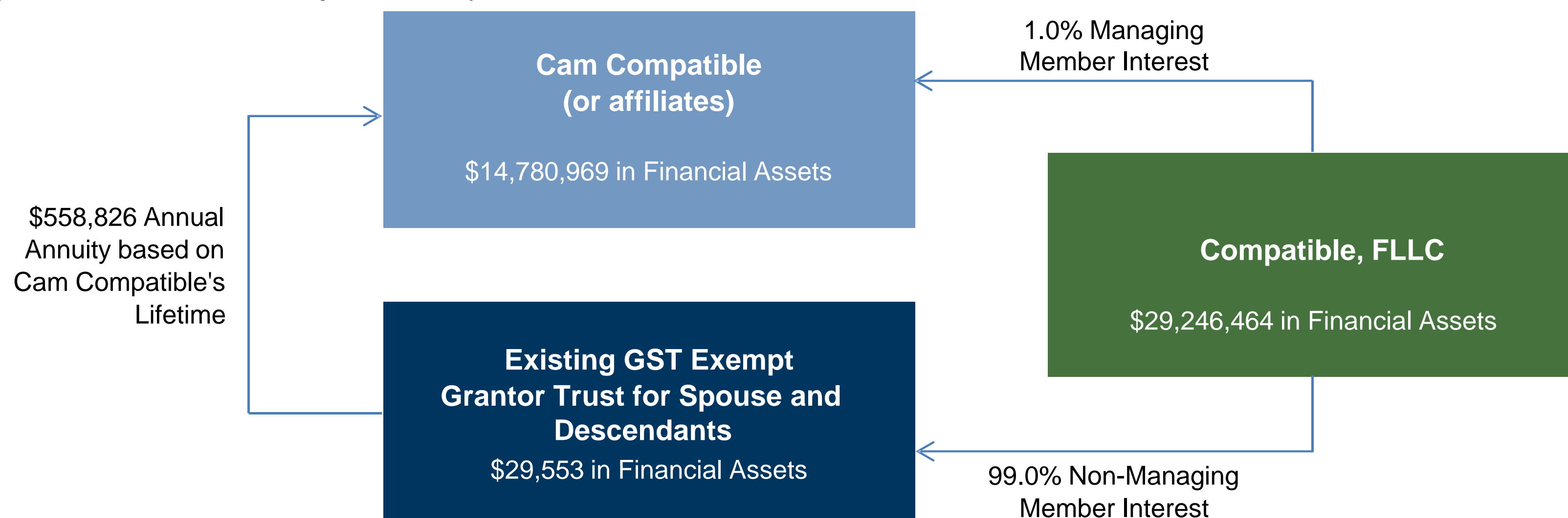
Example 6, Hypothetical Technique 2: Conversion of an Existing Note Receivable From a Grantor Trust to a Private Annuity

- Assume the same facts as Example 5, except four years later Cam Compatible, who at that time is 64 years of age could convert the balance of the note that is projected to be owed to him, $9,207,212, to a lifetime annuity that is equal to the value of the note. Assuming the IRC Sec. 7520 rate is 1.0%, that annual annuity will be equal to $558,826. Assuming the assets of Compatible, FLLC have been earning 7% pre-tax there should be $29,246,464 in financial assets in Compatible, FLLC to support that annuity. The note conversion to a lifetime annuity ("Hypothetical Technique #2a") is illustrated below:



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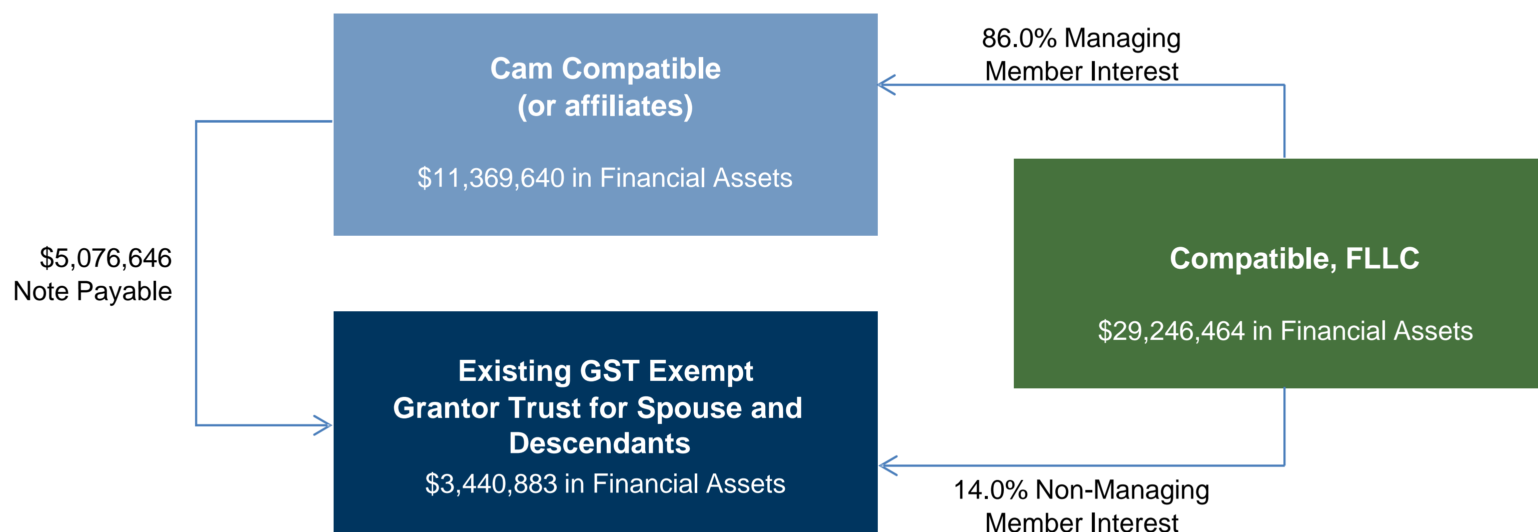
Example 7, Hypothetical Technique 3: Grantor Purchases 85% of the Grantor Trust Assets Four Years After the Trust is Formed With a Note That Pays a Fair Market Value Interest Rate

- Assume the same facts as Example 5, except after four years Cam Compatible purchases 85% of the non-managing member interests in Compatible, FLLC. The consideration for the purchase is forgiveness of Cam's existing note of $12,325,000 and the creation of a new note that Cam owes to the existing GST grantor trust of $5,076,646. Assume the fair market value interest rate on the note Cam owes to the existing GST grantor trust is 7.0%. The transaction ("Hypothetical Technique 3a") is illustrated below:



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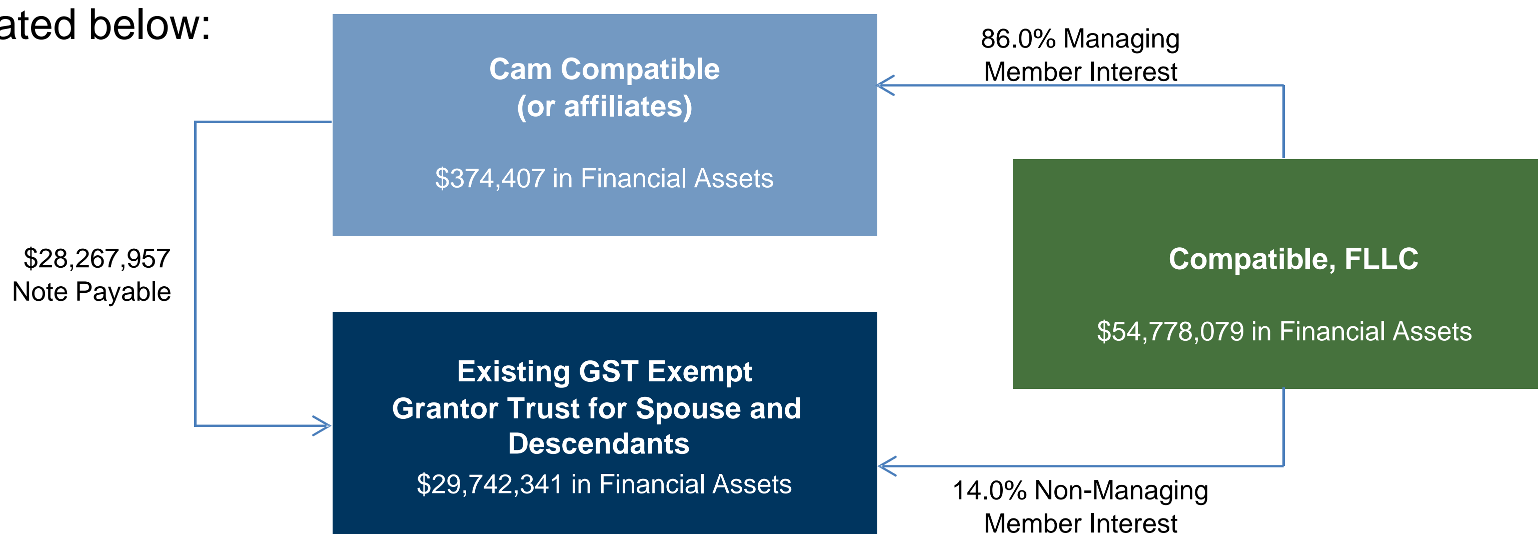
Example 8, Hypothetical Technique 4: Grantor Purchases 85% of the Grantor Trust Assets Twenty-Five Years After the Trust is Formed With a Note That Pays a Fair Market Value Interest Rate

- Assume the same facts as Example 5, except after 20 years after the existing GST grantor trust was formed, Cam purchases 85% of the non-managing member interests back from the existing GST grantor trust for a 7.0% note (the assumed fair market value interest rate) that has a principal balance of $28,267,957. The transaction ("Hypothetical Technique 4a") is illustrated below:



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Comparative Results of the Four Techniques Under the Assumptions of Examples 5 through 8, Including That the Original Basis of Cam Compatible's Assets is $2,500,000

- Assuming the assets in the FLLC had an original basis of $2,500,000, the results of the four techniques explored above, after consideration of the new estate tax rate, the new estate tax exemption (which increases with inflation), and capital gains taxes, are presented in the table below:

	Compatible Children	Compatible Children and Grandchildren	Consumption Direct Cost	Consumption Investment Opportunity Cost	IRS Income Tax	IRS Investment Opportunity Cost	Estate Taxes (@ 40.00%)	Total
	Total to All Descendants							
25-Year Future Values								
No Further Planning: Bequeaths Estate to Family (assumes $6.0mm estate tax exemption available)	$42,888,402	$33,129,497	$9,114,816	$11,720,526	$34,998,199	$40,371,299	$28,592,268	$200,815,008
	$76,017,899							
Hypothetical Technique #1a: Sale of FLLC Non-Managing Member Interests to the Existing GST Exempt Grantor Trust; Bequeaths Estate to Family (assumes $6.0mm estate tax exemption available)	$4,642,641	$79,296,783	$9,114,816	$11,720,526	$52,707,141	$40,371,299	$2,961,802	$200,815,008
	$83,939,424							
Hypothetical Technique #2a: Sale of FLLC Non-Managing Member Interests to the Existing GST Exempt Grantor Trust; Note Converts to a Private Annuity After Year 4; Bequeaths Estate to Family (assumes $6.0mm estate tax exemption available)	$3,082,835	$81,792,602	$9,114,816	$11,720,526	$52,810,999	$40,371,299	$1,921,931	$200,815,008
	$84,875,436							
Hypothetical Technique #3a: Sale of FLLC Non-Managing Member Interests to the Existing GST Exempt Grantor Trust; Purchases 85% of Non-Managing Member Interests from Trust After Year 4; Bequeaths Estate to Family (assumes $6.0mm estate tax exemption available)	$33,510,288	$52,702,530	$9,114,816	$11,720,526	$42,174,453	$40,371,299	$11,221,096	$200,815,008
	$86,212,818							
Hypothetical Technique #4a: Sale of FLLC Non-Managing Member Interests to the Existing GST Exempt Grantor Trust; Purchases 85% of Non-Managing Member Interests from Trust After Year 20; Bequeaths Estate to Family (assumes $6.0mm estate tax exemption available)	$3,206,879	$93,679,104	$9,114,816	$11,720,526	$40,584,465	$40,371,299	$2,137,919	$200,815,008
	$96,885,982							

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Comparative Results of the Four Techniques Under the Assumptions of Examples 5 through 8, Including That the Original Basis of Cam Compatible's Assets is $25,000,000

- Assuming the assets in the FLLC had an original basis of $25,000,000, the results of the four techniques explored above, after consideration of the new estate tax rate, the new estate tax exemption (which increases with inflation), and capital gains taxes, are presented in the table below:

	Compatible Children	Compatible Children and Grandchildren	Consumption Direct Cost	Consumption Investment Opportunity Cost	IRS Income Tax	IRS Investment Opportunity Cost	Estate Taxes (@ 40.00%)	Total
	Total to All Descendants							
25-Year Future Values								
No Further Planning: Bequeaths Estate to Family (assumes $6.0mm estate tax exemption available)	$42,888,402	$33,129,497	$9,114,816	$11,720,526	$34,998,199	$40,371,299	$28,592,268	$200,815,008
	$76,017,899							
Hypothetical Technique #1b: Sale of FLLC Non-Managing Member Interests to the Existing GST Exempt Grantor Trust; Bequeaths Estate to Family (assumes $6.0mm estate tax exemption available)	$4,652,766	$84,865,533	$9,114,816	$11,720,526	$47,121,516	$40,371,299	$2,968,552	$200,815,008
	$89,518,299							
Hypothetical Technique #2b: Sale of FLLC Non-Managing Member Interests to the Existing GST Exempt Grantor Trust; Note Converts to a Private Annuity After Year 4; Bequeaths Estate to Family (assumes $6.0mm estate tax exemption available)	$3,092,960	$87,361,352	$9,114,816	$11,720,526	$47,225,374	$40,371,299	$1,928,681	$200,815,008
	$90,454,311							
Hypothetical Technique #3b: Sale of FLLC Non-Managing Member Interests to the Existing GST Exempt Grantor Trust; Purchases 85% of Non-Managing Member Interests from Trust After Year 4; Bequeaths Estate to Family (assumes $6.0mm estate tax exemption available)	$34,381,038	$53,490,030	$9,114,816	$11,720,526	$39,935,703	$40,371,299	$11,801,596	$200,815,008
	$87,871,068							
Hypothetical Technique #4b: Sale of FLLC Non-Managing Member Interests to the Existing GST Exempt Grantor Trust; Purchases 85% of Non-Managing Member Interests from Trust After Year 20; Bequeaths Estate to Family (assumes $6.0mm estate tax exemption available)	$4,038,929	$94,431,604	$9,114,816	$11,720,526	$38,445,215	$40,371,299	$2,692,619	$200,815,008
	$98,470,532							

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Conclusions With Respect to the Four Techniques Discussed Above

- The best result is if Cam Compatible has the patience to wait 20 years before the non-managing member interests are purchased back.
- The advantage of purchasing the non-managing member interests is the partial step-up in basis obtained for the deemed estate tax value of the non-managing member interests under IRC Sec. 1014, which can be allocated to some of the underlying assets of the FLLC pursuant of IRC Sec. 754.
- All of these techniques illustrate that Cam can retain investment management of his assets and have access to the cash flow necessary for his consumption needs (which are assumed to be over $9,000,000 over the 24 year period of Cam's life).
- The disadvantage of waiting 20 years for the "buy-back" is that Cam may die before the planned purchase, in which case the technique would not be as productive because there will not be a step up in basis on the assets of the FLLC, except for the 1.0% managing member interest that Cam owned.

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Considerations

- There may need to be substantive equity in the trust from prior gifts (is 10% equity enough?) before the sale is made.
- State income tax considerations.
- The IRS could be successful in applying the step transaction doctrine to the technique.
  - Under the circumstances of the sale to a grantor trust, the crucial key to not run afoul of the step transaction doctrine may be establishing that the creation of the FLP or FLLC should stand on its own. Could the act of a transferor creating a FLP or FLLC be independently separated from the gift and/or sale to the trust? The creation of the FLP or FLLC should be designed to be sufficiently independent on its own and as an act that does not require a gift and/or sale to the trust.
- If the assets decrease in value, the gift tax exemption equivalent may not be recoverable.
- There may be capital gains consequences with respect to the notes receivables and/or payables that may exist at death. This consideration could be mitigated with the help of a third party lender. For instance, if a grantor has a payable to a grantor trust, the grantor could borrow cash from the third party lender and pay the balance of the grantor trust payable at a later time, the grantor could borrow cash from the grantor trust and pay the third party lender.
- 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.

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A Key Consideration is That 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 (Pages 90 – 110 of the Paper)

Conventional Wisdom:

- "The IRS will always contest the valuation of a FLP because the IRS could increase the transfer taxes, if they can demonstrate that the valuation discount is too high;"
- "All valuation clauses in an assignment document are against public policy."

This "conventional wisdom," under the circumstances discussed below, is incorrect.

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Formula Testamentary Disclaimers With Excess Passing to Charity

- Assume a client and/or her family has some charitable intent. That intent could be incorporated in a plan in order to help bring finality to an "open" valuation question. Additionally, that charitable intent could preclude the Service from unfairly contesting a good faith appraisal of the interest in the family entity as of that client's death. Consider the following example:

Example 9: Disclaimer Formula Gift to a Charity

Sally Saint dies with most of her assets in a FLP interest. The underlying asset value of Sally's interest in the partnership, if the partnership were liquidated, would be $10,000,000. Audrey Appraiser, however, believes a willing buyer would only pay $6,500,000 for Sally's interest in the partnership. Sally's will provides that the residue of her estate passes to her daughter Connie Clever. The will also provides that if Connie disclaims, or partially disclaims, an interest in her estate that asset, or assets, will pass to her donor advised fund in the Greater Metro Community Foundation. Connie partially disclaims that part of Sally's estate that she would otherwise receive that has a "fair market value that exceeds $6,400,000." "Fair market value" is defined in the disclaimer document the same way it is defined in the Treasury regulations. The charity hires independent counsel and an independent expert appraiser. After the charity consults with its advisors, it agrees with Audrey Appraiser's appraisal. The charity, approximately one year after Sally's death, sells its rights under the disclaimer document for $100,000 to Connie. The IRS audits the Saint Estate one year after the sale. The IRS believes the discount is excessive and the charity should have sold its interest for $1,000,000. What happens now?

- It would appear that no matter what the size of Sally Saint's estate, the Service should only collect revenues on the first $6,400,000 of her estate. The remainder of Sally Saint's estate (as a matter of state property law) goes to charity. Thus, assuming a good faith appraisal report is made and is persuasive to the independent charity, the Service may accept the estate tax return as filed with the discounts that are shown in that appraisal. The value of the gift to Connie Clever for state law property and estate tax purposes should be the same – $6,400,000. See *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008), *aff'd* 586 F.3d 1061 (8th Cir. 2009).

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Example 10: Gift or Sale of Limited Partnership Interest to a Grantor Trust and a Gift Charity

Steve owns a 99% FLP interest in Supersavers FLP. The interest is appraised for $3,000,000. Steve creates a grantor trust with an independent trustee and funds that trust with $400,000. Steve transfers his 99% interest in Supersavers as follows: (i) Steve assigns to the trust that fraction of his interest the numerator of which is $2,950,000 and the denominator of which is the fair market value of the interest and (ii) the excess to a public charity. Steve’s instrument of assignment provides that the fraction to be allocated to each transferee is to be determined using the value of Steve's interest in Supersavers determined under the principles of Rev. Rul. 59-60. The trust gives Steve a note for $2,950,000. (Alternatively, Steve could gift the interest to the trust.) Subsequently, but prior to any audit of the transaction by the IRS, the trust and the charity negotiate an agreement determining what fraction each is entitled to own and the trust purchases the charity’s interest for $50,000. Steve does not participate in the negotiations. Steve deducts the value of the interest given to charity. The IRS audits the transaction and decides that the value of Steve's transferred interest in Supersavers was $4,000,000 instead of $3,000,000, so that the fraction allocated to the trust by the agreement between the trustee and the public charity is too great (and the amount paid by the trust for the charity’s interest is too small). The IRS asserts that Steve made a gift to the trust of $1,000,000, the excess of what the trust has actually received over the face amount of the promissory note.

- Since Steve had no role in determining the arrangements between the trust and the charity, how can it be that Steve has made a gift? If the amount allocated to charity was too small, is Steve entitled to an additional income tax deduction? See *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006); *Estate of Anne Y. Petter v. Commissioner*, T.C. Memo 2009-280 (December 7, 2009); and *John H. Hendrix and Karolyn M. Hendrix, Donors v. Commissioner*, T.C. Memo 2011-133 (June 15, 2011).

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The Defined Value Allocation Formula Gift

- Certain conclusions that may be drawn from the *Petter*, *Hendrix*, *Christiansen* and *McCord* cases:
  - These cases strongly suggests that the Tax Court would be prepared to allow defined value allocation formula clauses, with a gift over to entities or trusts other than charities, which incorporates the phrase "as finally determined for federal gift tax purposes."
  - The addition of the phrase "as finally determined for federal gift tax purposes" was obviously found to be an unnecessary addition by the Tax Court and the Fifth Circuit. There may be key reasons why a donor, in his assignment document, would not wish to add that phrase. One reason is a practical one: over ten years is too long to wait to find out the result of who owns what in assignment of a closely enterprise (the facts of *McCord*). Another reason may be a tactical one: an arms-length transaction is the best evidence of value.
  - It should be noted that in *King v. United States*, 545 F.2d 700 (10th Cir. 1976), the Tenth Circuit also found that *Proctor* did not apply where the transaction did not contain "contingencies which, upon fruition, alter, change or destroy the nature of the transaction."
- Besides a formula sell using a public charity, the recipient of the "gift over" in the defined value allocation formula that uses the phrase "as finally determined for federal gift tax purposes" could be: a spouse; or an independent trustee of a marital deduction trust or grantor retained annuity trust (GRAT). The trustee (or spouse) should independently review the valuation of the transferred assets.

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The Defined Value Allocation Formula Gift (Continued)

- Defined value clauses could cause practical problems as to the administration of the transferred property before a final determination has been made as to the portion of the property that has actually been transferred. For instance, issues may arise as to the distribution of income earned on the transferred property, the exercise of ownership rights and the reporting of the income for income tax purposes.
- Generally, a possible solution to these issues is using a trustee as the transferee of the legal title to the property. The defined value allocation formula clause could be a clause internal to the trust document creating the trust and could direct that the trustee is to allocate the interest in the hard to value asset between two trusts in which the trustee is the trustee. One trust could be held for the benefit of the client's family and the other trust is held in a manner that is not subject to gift tax. In a similar fashion perhaps an escrow agent could also be utilized.
- In order to steer clear of certain income tax reporting uncertainties it is recommended that all of the "transferee" trusts be considered potentially defective grantor trusts.

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Defined Value Allocation Clauses Involving a Defined Dollar Transfer By the Donor

- *Wandry v. Commissioner,* (T.C. No. 10751-09, T.C. Memo. 2012-88, March 26, 2012, nonacq.) also allowed a dollar defined valuation formula where there was no gift over to a charity (or marital deduction trust or a GRAT) and the excess of the transfer under the formula reverted to the transferor.
- In the *Wandry* case, the tax court, in a memorandum opinion, upheld a defined dollar formula transfer of member units in a LLC that had a value equal to "$X as determined for federal gift tax purposes."
- The tax court held there was no additional gift tax even though there was a subsequent adjustment of the transferred units.
- The IRS subsequently filed a nonacquiescence in the case. I.R.B. 2012-46.

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Example 13: Defined Dollar Formula by a Donor in 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. At the same time the assignment is made, the trustee executes a qualified formula disclaimer using the same parallel language in the dollar defined assignment. The trust document provides that the trustee has the power to disclaim any contributed property, and if any property is disclaimed, it will revert to the grantor of the property. 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 inadvertently held by the trustee is only held in an agency capacity for the benefit of the grantor and that the property held in that agency capacity may be comingled with the trust property until it is returned to the grantor.

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- The argument for using the formula disclaimer by the trustee, 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 Treasury Regulation Section 25.2518-3(b), examples 15 and 20.
- 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 could assign those extra interests (that are held under the 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.

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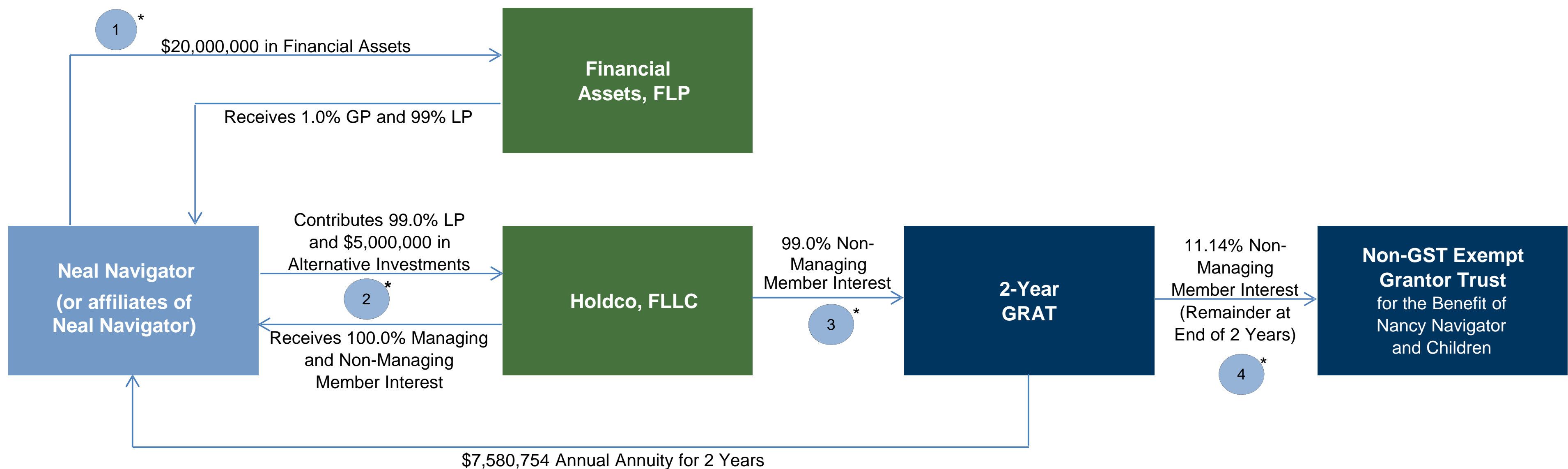
Example 14, Hypothetical Technique 5: Contribution of a FLLC Member Interest to a GRAT, is illustrated below:



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

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Advantages of Contributing FLLC Assets to a GRAT

- There is a smaller annuity amount owed to the grantor. To the extent the annuity amount is paid with cash, a greater amount will pass to the remainderman trust. See Tables 2a, 2b and 2c.
- Valuation advantage of a GRAT.
- Ability of grantor to pay for income taxes associated with GRAT gift tax-free and substitute assets of the GRAT income tax-free.
- Synergy with other techniques.
- Comparatively low hurdle rate.
- High leverage.
- Non-recourse risk to remaindermen.
- Consumption and flexibility advantage of remainder trust for the benefit of a spouse who has a limited power of appointment.

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Considerations of Contributing FLLC Assets to a GRAT

- Part or all of the FLLC Interests could be taxable in the grantor's estate if the grantor does not survive the term of the GRAT.
- If a GRAT is not administered properly the retained interest by the grantor may not be deemed to be a qualified interest.
- The *Atkinson* worry.
- The annuity amount must be paid annually.
- Paying the grantor in satisfaction of his retained annuity interest with hard to value assets (i.e., the member interests in the FLLC) may disqualify his retained interest from being a qualified interest, if the assets are valued improperly.
- It is difficult to do GST planning because of the ETIP rules.

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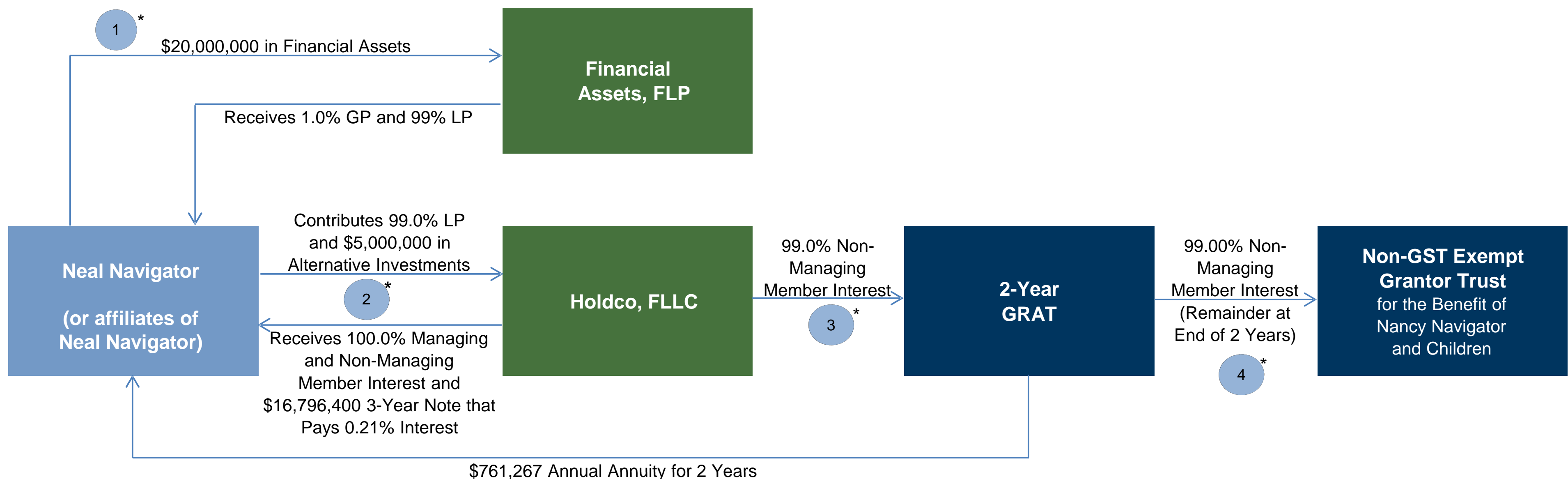
- A taxpayer could create a single member FLLC by contributing and selling financial and private equity assets to the FLLC. If the taxpayer is the only owner of the FLLC there should not be any income taxes or gift taxes associated with the creation of the FLLC. The taxpayer could then contribute some or all of the FLLC member interests to a GRAT.

Example 15, Hypothetical Technique 6: Contribution of a Leveraged FLLC Member Interest to a GRAT, is illustrated below:



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

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Table 2a: Certain Comparisons of Hypothetical Techniques 5, 6 and 7: (Assuming Financial Assets Earn 1.40% Annually and Alternative Investments Earn 1.40% Annually)

Hypothetical Techniques: Financial Assets Earn 1.40% Annually and Alternative Investments Earn 1.40% Annually	Neal Navigator	Navigator Children	% Improvement Over Hypothetical Technique 1	% Improvement Over Hypothetical Technique 2
Holdco, FLLC Distributes about 2% of the value of assets it owns directly and indirectly.				
No Further Planning	$32,721,231	$0	N/A	N/A
Contribution of Assets to a 2-Year GRAT; Remaindermen of GRAT is a Non-GST Grantor Trust	$32,569,515	$151,716	N/A	N/A
Hypothetical Technique 5: Creation of a FLP; Contribution of FLP Interests and Alternative Investments to a New FLLC (Holdco, FLLC) in Return for Managing and Non-Managing Member Interests (No Leverage); Contribution of Non-Managing Member Interests in Holdco to a 2-Year GRAT; Remaindermen of GRAT is a Non-GST Grantor Trust	$32,087,571	$633,660	317.66%	N/A
Hypothetical Technique 6: Creation of a FLP; Contribution of FLP Interests and Alternative Investments to a New FLLC (Holdco, FLLC) in Return for Managing and Non-Managing Member Interests and a Note; Contribution of Non-Managing Member Interests in Holdco to a 2-Year GRAT; Remaindermen of GRAT is a Non-GST Grantor Trust	$25,876,883	$6,844,348	4411.29%	980.13%

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Table 2b: Certain Comparisons of Hypothetical Techniques 5, 6 and 7: (Assuming Financial Assets Earn 7.50% Annually and Alternative Investments Earn 8.00% Annually)

Hypothetical Techniques: Financial Assets Earn 7.50% Annually and Alternative Investments Earn 8.00% Annually	Neal Navigator	Navigator Children	% Improvement Over Hypothetical Technique 1	% Improvement Over Hypothetical Technique 2
Holdco, FLLC Distributes about 2% of the value of assets it owns directly and indirectly.				
No Further Planning	$35,664,191	$0	N/A	N/A
Contribution of Assets to a 2-Year GRAT; Remaindermen of GRAT is a Non-GST Grantor Trust	$33,048,580	$2,615,612	N/A	N/A
Hypothetical Technique 5: Creation of a FLP; Contribution of FLP Interests and Alternative Investments to a New FLLC (Holdco, FLLC) in Return for Managing and Non-Managing Member Interests (No Leverage); Contribution of Non-Managing Member Interests in Holdco to a 2-Year GRAT; Remaindermen of GRAT is a Non-GST Grantor Trust	$32,582,731	$3,081,460	17.81%	N/A
Hypothetical Technique 6: Creation of a FLP; Contribution of FLP Interests and Alternative Investments to a New FLLC (Holdco, FLLC) in Return for Managing and Non-Managing Member Interests and a Note; Contribution of Non-Managing Member Interests in Holdco to a 2-Year GRAT; Remaindermen of GRAT is a Non-GST Grantor Trust	$25,688,170	$9,976,021	281.40%	223.74%

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Table 2c: Certain Comparisons of Hypothetical Techniques 5, 6 and 7: (Assuming Financial Assets Earn 10% Annually and Alternative Investments Earn 10% Annually)

Hypothetical Techniques: Financial Assets Earn 10.00% Annually and Alternative Investments Earn 10.00% Annually	Neal Navigator	Navigator Children	% Improvement Over Hypothetical Technique 1	% Improvement Over Hypothetical Technique 2
Holdco, FLLC Distributes about 2% of the value of assets it owns directly and indirectly.				
No Further Planning	$36,917,288	$0	N/A	N/A
Contribution of Assets to a 2-Year GRAT; Remaindermen of GRAT is a Non-GST Grantor Trust	$33,311,621	$3,605,667	N/A	N/A
Hypothetical Technique 5: Creation of a FLP; Contribution of FLP Interests and Alternative Investments to a New FLLC (Holdco, FLLC) in Return for Managing and Non-Managing Member Interests (No Leverage); Contribution of Non-Managing Member Interests in Holdco to a 2-Year GRAT; Remaindermen of GRAT is a Non-GST Grantor Trust	$33,263,285	$3,654,003	1.34%	N/A
Hypothetical Technique 6: Creation of a FLP; Contribution of FLP Interests and Alternative Investments to a New FLLC (Holdco, FLLC) in Return for Managing and Non-Managing Member Interests and a Note; Contribution of Non-Managing Member Interests in Holdco to a 2-Year GRAT; Remaindermen of GRAT is a Non-GST Grantor Trust	$25,677,760	$11,239,528	211.72%	207.59%

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Other Advantages of Contributing Leveraged FLLC Interests to a GRAT

- If leverage is used in creating the FLLC that is contributed to the GRAT, much more wealth is transferred to the remainderman of the GRAT.
- The technique has many of the same advantages as the sale to the grantor trust for the benefit of the transferor's spouse.
- Valuation advantage of a GRAT.
- Ability of grantor to pay for income taxes associated with GRAT gift tax-free and substitute assets of the GRAT income tax-free.
- Synergy with other techniques.
- Comparatively low hurdle rate.
- High leverage.
- Non-recourse risk to remaindermen.
- The "*Atkinson*" worry about paying a GRAT annuity with a hard-to-value asset may be eliminated.
- When leveraged FLLC interests are contributed to a GRAT, under the assumptions above, there is enough cash flow coming out of the FLLC to the GRAT to pay the annuity amounts during the Annuity Period in cash. This eliminates the problems associated with satisfying the GRAT annuity with hard to value assets.

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Other Advantages of Contributing Leveraged FLLC Interests to a GRAT (Continued)

- The notes associated with the sale to the FLLC before the GRAT is created may be finally satisfied by the remainder beneficiary with hard to value assets after the GRAT terminates. The use of payments in kind to satisfy the loan by the remainder beneficiary after the GRAT terminates does not run the "deemed contribution" danger that may be inherent in satisfying GRAT annuity payments with hard to value assets.
- The notes could be used to pay unanticipated cash flow needs, including needs based on unanticipated income tax events.

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Considerations of Contributing Leveraged FLLC Interests to a GRAT

- Part or all of the FLLC interests could be taxable in the grantor's estate if the grantor does not survive the term of the GRAT; however, because the retained annuity amount is relatively small, using the leveraged technique may produce a much better result under IRC Sec. 2036.
- It is more complex than the other GRAT techniques.

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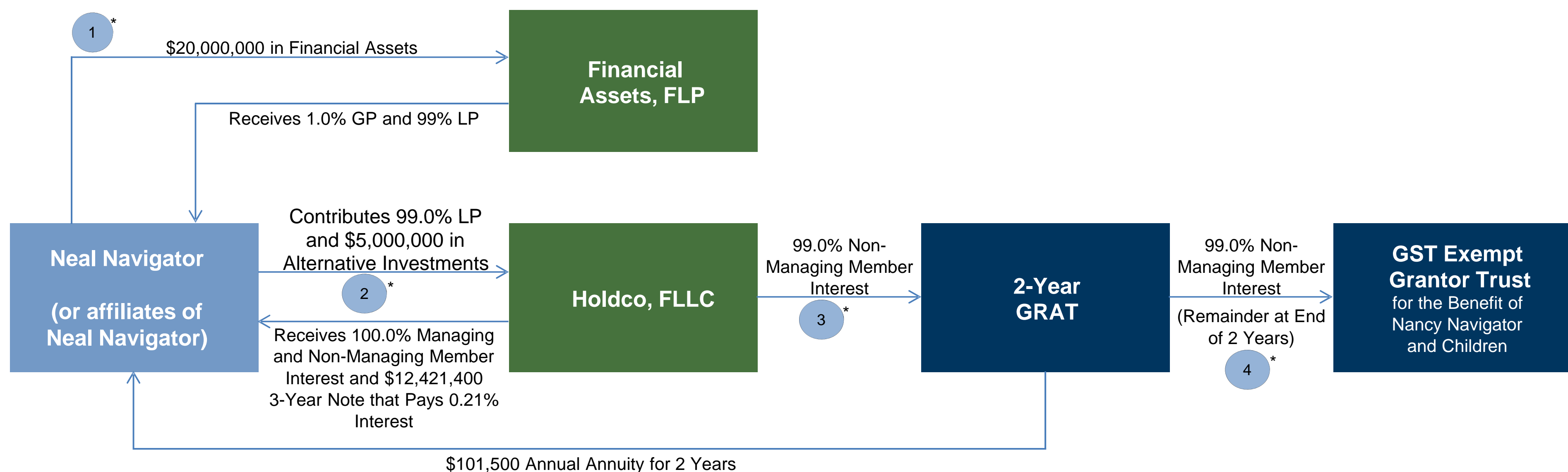
- Consider a defined formula remainder GRAT with a small retained annuity in comparison to the value of the asset that is contributed to the GRAT, because the annuity amount is defined as a result of a "defined value" remainder that is a specific dollar amount.

Example: 16, Hypothetical Technique 7: Neal Allocates Part of His Gift Tax Exemption and All of His GST Exemption to a GRAT That Owns a Leveraged FLLC and Pays a Very Small Annuity, is illustrated below:



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

- Neal, who is under 70 years of age, will allocate $4,800,000 of his gift tax exemption and $5,000,000 of his GST tax exemption to the GRAT.

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- Treas. Reg. Sec. 26.2632-1(c)(2) contains the regulatory definition of ETIP and then provides an exception, as follows:

> For purposes of paragraph (c)(2) of this section, the value of transferred property is not considered as being subject to inclusion in the gross estate of the transferor or the spouse of the transferor if the possibility that the property will be included is too remote as to be negligible. A possibility is so remote as to be negligible if it can be ascertained by actuarial standards that there is less than a 5% probability that the property will be included in the gross estate.

- For a short term GRAT (e.g., two years), except for a grantor who is above 70 years of age, the 5% exception noted above would apply.
- At least one way of reading the exception for a short term GRAT is that the ETIP rules will not apply to an allocation of GST exemption, because there is less than a 5% chance that the grantor will die during the GRAT term.
- Thus, can a grantor, age 70 or younger create a GRAT in which the remainderman is a GST trust, if the exception applies, make an allocation of the GST exemption that is equal to the amount of the net amount taxable gift of the GRAT remainder taking into account the retained annuity, and produce a zero inclusion ratio for generation skipping tax purposes? Or must the grantor make an allocation of his GST exemption of the gross amount of assets contributed to the GRAT and not net out the retained annuity?

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Allocating the GST and Gift Tax Exemption to a Leveraged GRAT (Continued)

- There is not any definitive authority on this subject, but most commentators believe the IRS will insist that the answer to the first question is "no" and the answer to the second questions is "yes".
- In this GRAT example, it does not matter if the IRS answers the second question with a "yes." That is because the retained annuity is relatively small and a GST exemption allocation of around $5,000,000 will make the entire trust GST exempt (since the GRAT's entire gross value, without subtracting the value of the small retained annuity, is less than $5,000,000).
- The formula defines the annuity as that percentage of the initial value of the trust assets (as finally determined for federal gift tax purposes) which will result in an annuity having a present value at the inception of the trust equal to the initial value of the trust assets (as so determined) less $4,800,000. A GRAT annuity defined in this way has not been passed upon by the IRS in revenue rulings or the courts.
- It should meet the requirements of Treas. Reg. 25.2702-3(b)(i)(B), which permits the annuity to be "[a] fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, payable periodically but not less frequently than annually, but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year."
- In order to freeze the remainder value at a constant dollar amount, such a formula definition generates a greater annuity percentage (not just a greater annuity amount) for a higher initial value. The percentage is dependent upon finally-determined asset values and is fixed by them, since there is only one percentage corresponding to any given initial value of the trust.

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Allocating the GST and Gift Tax Exemption to a Leveraged GRAT (Continued)

- It therefore is hard to see in what sense this would not be a "fixed percentage," and the regulatory definition, with its reference to values "as finally determined for federal tax purposes," seems entirely consistent with defining the annuity percentage in this way.
- Advantages:
  - If leverage is used in creating the FLLC that is contributed to the GRAT, much more wealth is transferred to the remainderman of the GRAT.
  - Valuation advantage of a GRAT.
  - Ability of grantor to pay for income taxes association with the GRAT gift tax free and substitute assets of the GRAT income tax free.
  - Synergy with other techniques.
  - Comparatively low hurdle rate.
  - A much smaller part of the FLLC interest will be taxed on the grantor's estate if the grantor does not survive the term of the GRAT in comparison to the contribution of a non leveraged FLLC to a GRAT, or a leveraged FLLC to a GRAT without the allocation of the gift tax exemption.
  - The "*Atkinson*" worry about paying a GRAT annuity with a hard to value asset may be eliminated.

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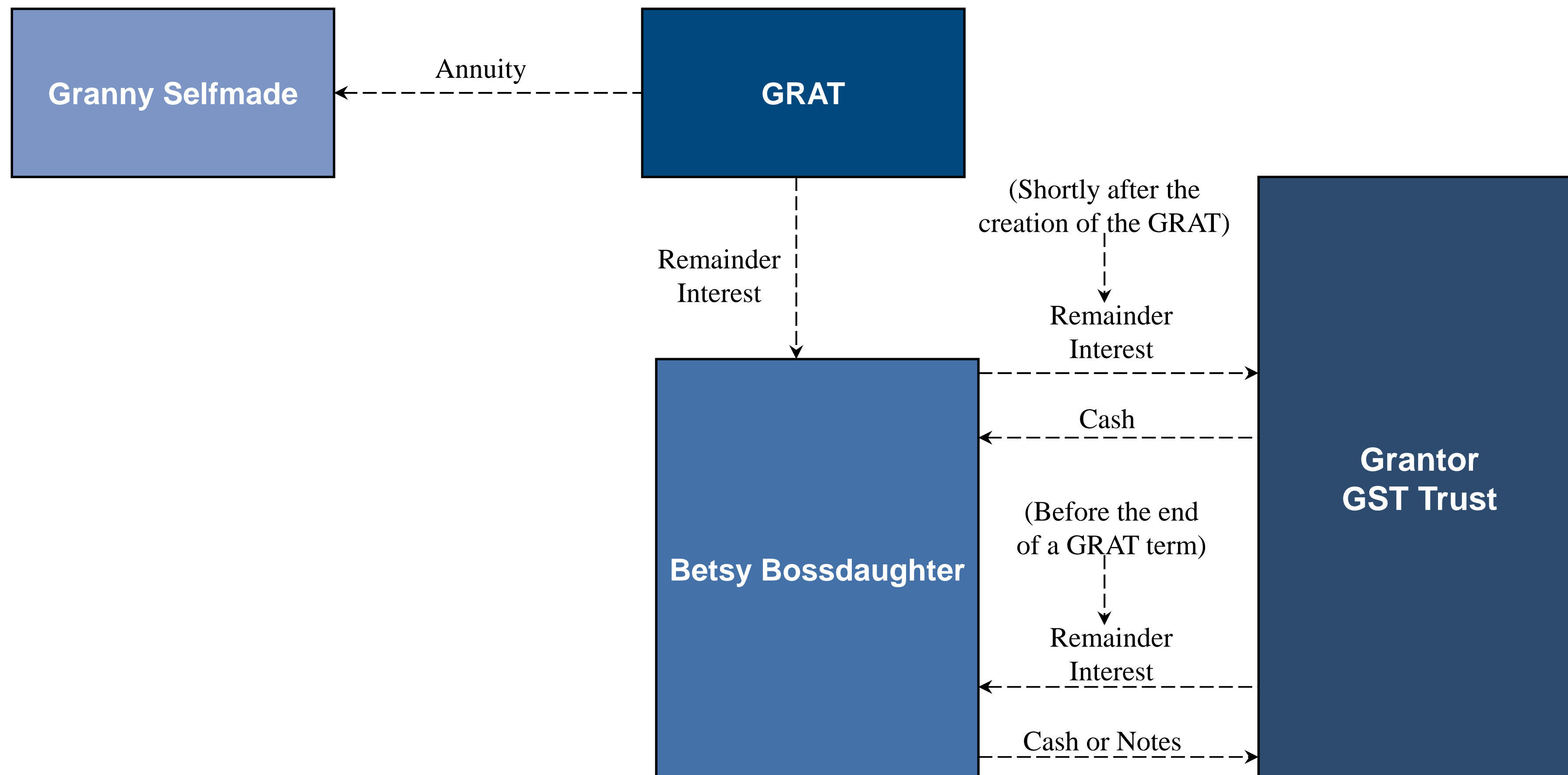
Considerations of the Leveraged GRAT in Which Exemptions Are Used. There May Exist Better Techniques For Transferring a GRAT Remainder Interest to a GST: Using the Leverage of a GRAT to Indirectly Profit a GST Trust – Non-Skip Person Exception



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- See private letter ruling 200107015. The private letter ruling's basic holding can be viewed as uniquely applicable to the charitable lead annuity trust. However, it is clear that the IRS will look for other opportunities to apply equitable doctrines in similar contexts. Stated differently, the ruling's reasoning could apply just as easily to a GRAT, if the reader substituted the phrase "ETIP rules" for "IRC Sec. 2642(e)."
- Using the same logic, the Service could find that a gift by a GRAT remainderman is counter to the Congressional intent of enacting the ETIP rules. However, would the equitable doctrines inherent in the ruling apply to a sale by Betsy? It would appear that the answer may be no.
- In using a sale for full and adequate consideration, the issue is not whether Granny or Betsy is the transferor of the property that moves from the GRAT to the dynasty trust. The issue is whether there is an addition to the dynasty trust for GST purposes. There should not be an addition to the dynasty trust for GST purposes when Betsy transfers the remainder interest to the GST trust for full and adequate consideration and when Betsy buys the remainder interest back for full and adequate consideration.

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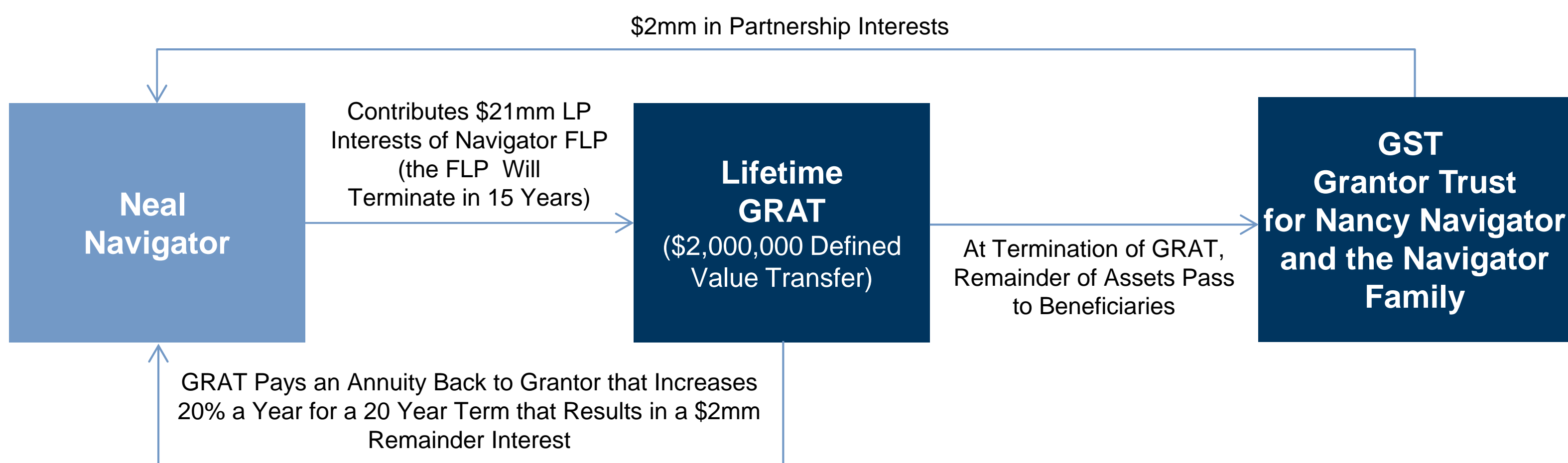
- Consider a GRAT that is created with a substantial remainder interest, however, because of a purchase of a remainder interest of the GRAT, there is not a gift. That is, instead of making a gift of the remainder interest, what if the grantor of a GRAT sold it for full and adequate consideration to a pre-existing trust? IRC Sec. 2036 inclusion does not apply if the grantor dies before the GRAT term ends, and as a consequence, the ETIP limitation may also not apply and the creation of the GRAT may not constitute a transfer to the GST trust.

Example 18, Hypothetical Technique 8: Neal Enters Into a GRAT With the Remainderman Being a Generation-Skipping Transfer Trust With the Generation-Skipping Transfer Trust Purchasing the Remainder Interest For Full Consideration, is illustrated below



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- Please note in the table below, which delineates the amount that is projected to be transferred to Neal's children, grandchildren and great grandchildren pursuant to this technique in comparison to not doing any further planning with respect to the partnership. The table below assumes Neal's death at the end of year 20, Neal consumes $100,000 a year with a 3% inflation rate, an 7% pre-tax rate of return with 3% being taxed at ordinary income rates (44.6%) and 4% at capital gains rates (25%, with a 30% turnover). The table below assumes Neal has $1,500,000 of assets outside the FLP. Assume that the FLP, at the time of the creation of the split purchase GRAT, has only 15 years remaining and that the valuation discount is 30%:

20-Year Future Values	Navigator Children	Navigator GST Exempt Trust	Consumption Direct Cost	Consumption - Investment Opportunity Cost	IRS - Income Tax	IRS - Investment Opportunity Costs	IRS - Estate Tax (at 40%)	Total
No Further Planning; Bequeaths Estate to Family (assumes $16.96mm estate tax exemption available)	$39,539,304	$28,020,410	$2,687,037	$2,471,896	$25,853,747	$21,563,267	$26,359,536	$146,495,198
Hypothetical Technique #8a: 20 Year Term Scenario; Bequeaths Remaining Estate to Family (assumes $16.96mm estate tax exemption available)	$3,977,723	$87,649,731	$2,687,037	$2,471,896	$28,145,543	$21,563,267	$0	$146,495,198

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Information related to amounts and rates set forth under U.S. tax laws are drawn from current public sources, including the Internal Revenue Code of 1986, as amended, as well as regulations and other public pronouncements of the U.S. Treasury Department and Internal Revenue Service. Such information may be subject to change without notice. In some cases, rates may be estimated and may vary based on your particular circumstances.

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- The results are obviously very significant. Will this work? An argument can certainly be made that the creation of the split purchase GRAT is not subject to the ETIP rules and the creation of the GRAT does not constitute a transfer to the GST trust. If Neal died during the 20 year term of the GRAT, the GRAT property will not be includible in his gross estate, only the value of the remaining annuity payments would be included. Alternatively, the GRAT annuity period could be set for the shorter of 20 years or the death of Neal. Obviously, the GRAT annuity payment would have to be set at a higher amount in order to provide adequate and full consideration to Neal. If Neal died earlier than 20 years there would be significant income tax and estate tax advantages in structuring the GRAT term in that manner. See Table 9b on the following page.
- There could be abusive situations where the remainder interest is very small and the logic of the *Wheeler*, *D'Ambrosio* and *Magnin* cases would not be applied.
- However, under the facts assumed in this case, the remainder interest is significant and would seem to be analogous to the remainderman values considered in the above Circuit Court cases.

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Assume the same facts as the above table, except the annuity amount is higher because the GRAT terminates on the earlier of Lenny's death or 20 years:

20-Year Future Values	Navigator Children	Navigator GST Exempt Trust	Consumption - Direct Cost	Consumption - Investment Opportunity Cost	IRS - Income Tax	IRS - Investment Opportunity Costs	IRS - Estate Tax (at 40%)	Total
No Further Planning; Bequeaths Estate to Family (assumes $16.96mm estate tax exemption available)	$39,539,304	$28,020,410	$2,687,037	$2,471,896	$25,853,747	$21,563,267	$26,359,536	$146,495,198
Hypothetical Technique #8b: Shorter of Neal Navigator's Death or 20 Years Scenario; Bequeaths Remaining Estate to Family (assumes $16.96mm estate tax exemption available)	$8,218,735	$83,488,658	$2,687,037	$2,471,896	$28,065,604	$21,563,267	$0	$146,495,198

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Fifth "Sales" Method: The Advantages and Considerations of a Transferor Gifting and Selling Limited Partnership Interests to a Trust That Qualifies For the Marital Deduction With the Remainderman Being a Trust Which Purchases the Remainder ("Remainder Purchase Marital Trust") (Pages 134 – 140 of the Paper)

- The Remainder Purchase Marital Trust, which is sometimes referred to as the "RPM Trust," involves a transfer of assets to a trust in which donor's spouse has an income or annuity interest for a specified term or life.
- The remainder of the RPM passes to a separate trust (the "Remaindeman Trust"), which could be a generation-skipping trust.
- The transfer to the trust is gift tax free because (i) the spouse's income or annuity interest in the RPM Trust qualifies for the gift tax marital deduction, and (ii) the Remainderman Trust pays the donor the actuarial value of the remainder interest when the RPM Trust is created.
- The RPM Trust assets are not included in either the donor's estate (because the donor has no retained interest in the trust) or the spouse's estate (because the spouse does not have a general power of appointment and there is no QTIP election).

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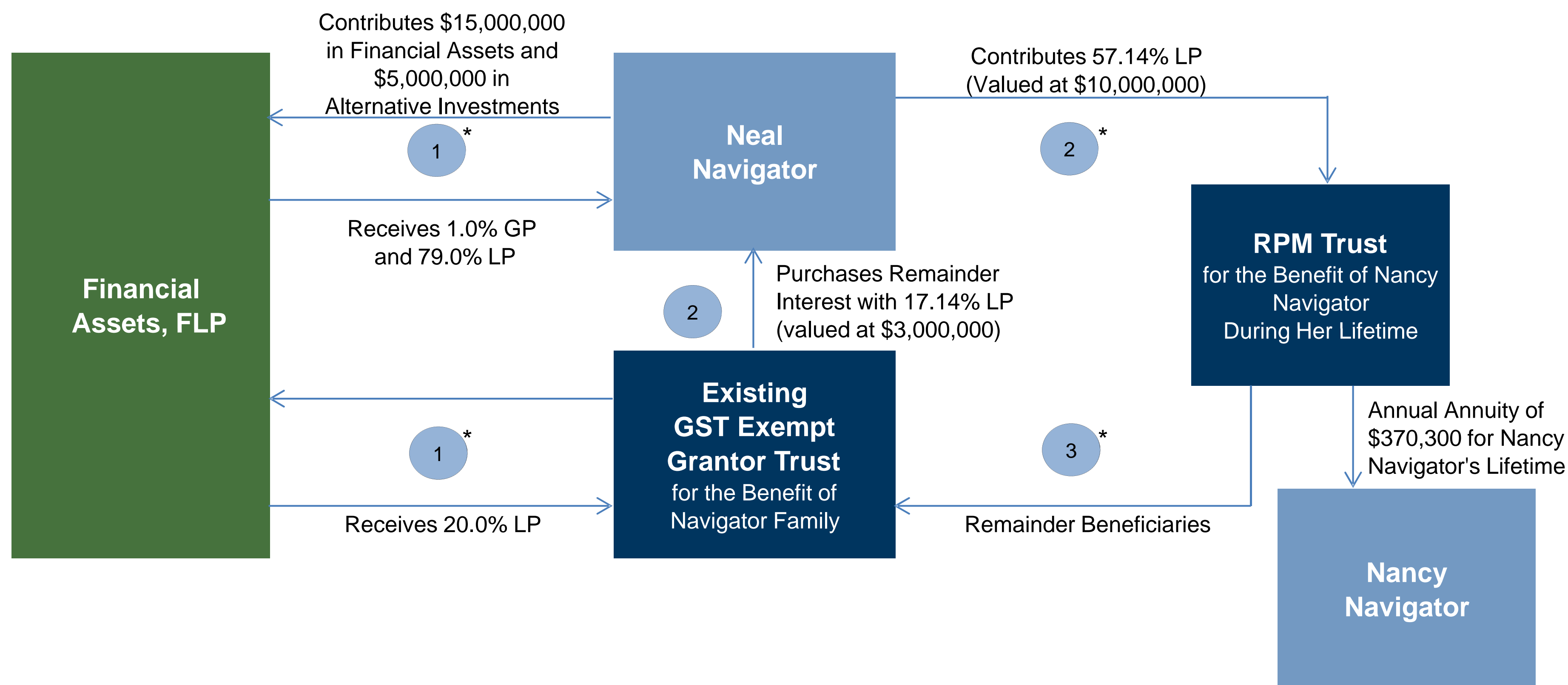
Example 19, Hypothetical Technique 9: Creation of a Remainder Purchase Marital Trust, is illustrated below:



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The Advantages and Considerations of a Transferor Gifting and Selling Limited Partnership Interests to a Remainder Purchase Marital Trust (Continued)

- It is important that Nancy Leverage only has a straight income or annuity interest in the RPM Trust. If she has the right to receive distributions under an ascertainable or discretionary standard, her interest would be hard to value and it would be very difficult to effectuate the technique.
- IRC Sec. 2523(b)(1) provides that no gift tax marital deduction is allowed if the spouse receives a life estate or other interest in a trust and upon termination of the trust the trust assets pass to someone else “for less than adequate and full consideration in money or money’s worth” (the so-called “terminable interest rule”).
- Thus, it is crucial, in order to not run afoul of the terminable interest rule, that full consideration be paid for the remainder interest of the RPM Trust.
- The RPM Trust could provide that all of the income or an annuity amount goes to the grantor’s spouse. Generally, at times of high interest rates it is more advantageous to provide income interest for the donor spouse and in times of low interest rates, it is more advantageous to provide for an annuity for the donor’s spouse.

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Advantages of Using a RPM Trust

- Tax advantages of creating a grantor trust.
- The near term death of grantor, or the grantor's spouse, generally does not affect the technique like the death of a grantor of a GRAT.
- The appreciation of the assets will be out of the grantor's estate and the spouse of the grantor's estate.
- The grantor and the grantor's spouse will have available for their consumption needs the consideration paid by the Remainderman Trust and the distributions paid pursuant to the beneficial provisions of the RPM Trust (and perhaps the Remainderman Trust).
- There is more flexibility in the design of the structure in comparison to a GRAT because IRC Sec. 2702 does not apply to the technique and it is easier to do leveraged GST planning in comparison to a GRAT.
- The technique could also serve as a qualified personal residence trust (QPRT) substitute and may be a good vehicle to transfer art. The grantor's spouse could have an income interest in the RPM Trust. Further leverage could be obtained by selling the residence and/or art to the RPM Trust for a note.

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Considerations of Using a RPM Trust

- It requires a spouse beneficiary.
- The RPM Trust cannot have a divorce clause. It should be noted that this technique could be appropriate in certain pre-divorce planning situations.
- It is crucial that the Remainderman Trust pay full consideration. Consider only using easy to value assets or proportional interests in the same entity with this technique.
- The step transaction doctrine could apply.
- The need for "substance" with respect to the purchase by the Remainderman Trust.
- It is crucial that the remainder and term interests in the RPM Trust be transferred simultaneously. Consider creating the RPM Trust as a revocable trust that becomes irrevocable upon receipt of the consideration from the Remainderman Trust.

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- Sales to a Spousal Grantor Trust may constitute effective estate planning. Consider the following example:

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

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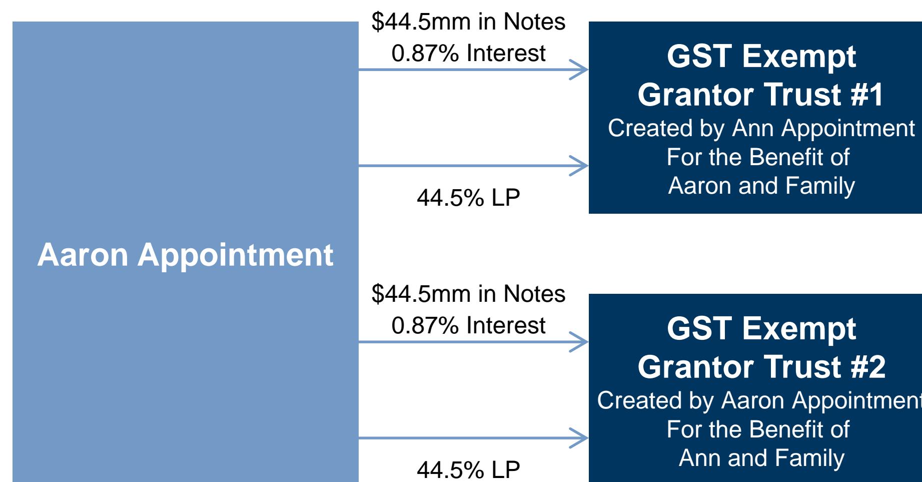
The Advantages and Considerations of a Transferor Selling Assets to a Spousal Grantor Trust) (Continued)

Private Wealth Management

- The proposed sale of partnership interest to a grantor trust and a spousal grantor trust 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

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Advantages of the Technique

- There will be no capital gains consequence on the original sale of the assets to the trust.
- The technique, with respect to a sale to the trust in which the seller has a power of appointment, has the potential of mitigating gift tax surprises.
- It has the advantage of allowing the transferor to be a beneficiary of the trust and have a power of appointment over the trust.
- Appreciation will be out of the transferor's estate.

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Considerations of the Technique

- There may need to be substantive equity in the trust from prior gifts (is 10% equity enough?) before the sale is made.
- Federal income tax considerations. The transferor will be taxed on the interest of the note; however, the transferor's spouse may have a corresponding deduction.
- State income tax considerations.
- Necessary to file gift tax returns.
- The family could lose the benefits of using the gift tax exemption, if the trust assets depreciate.
- The IRS could be successful in applying the step transaction doctrine to the technique.
- Reciprocal Trust Doctrine considerations.
- Creditor considerations, which could lead to estate tax concerns.
- Creditor considerations, which could lead to incomplete gift concerns.

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- 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 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 the 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. The beneficiary/transferor could sell certain assets to the Beneficiary Grantor Trust for a note that is guaranteed by another trust. The beneficiary/transferor is considered the owner of the trust for income tax purposes under IRC Sec. 678.

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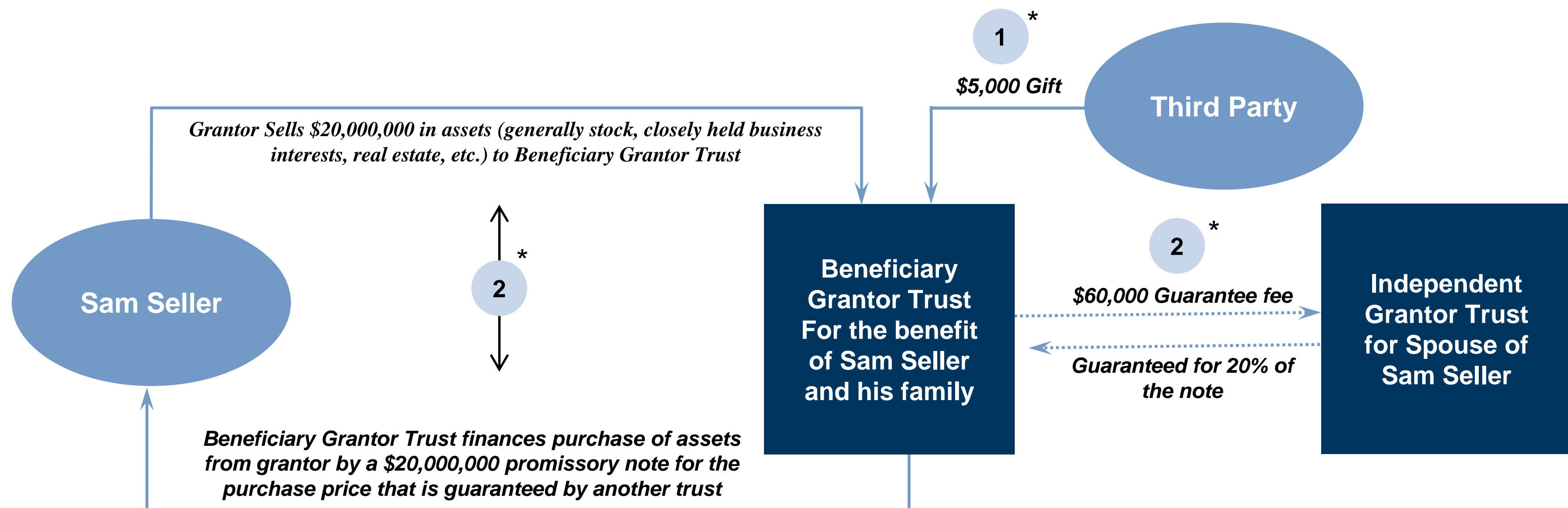
- This technique is illustrated as follows:



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

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Advantages of the 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 the future stewardship of the trust properties, without any estate tax consequences, if the transferor/beneficiary has a power of appointment over the trust.

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Considerations of the Technique

- In addition to the considerations that are inherent in a sale to a grantor trust, use of a Beneficiary Grantor Trust in this manner raises issues that are discussed below.
- 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 Beneficiary Grantor Trust. 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 Beneficiary Grantor Trust. Under this example, the corpus of the Beneficiary Grantor Trust 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.
- Who is the transferor for estate tax purposes?
  - 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 Beneficiary Grantor Trust, whether the Beneficiary's transfer is a gift or a sale.
  - If the Beneficiary's transfer is a sale rather than a gift, does the result change?

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Considerations of the Technique (Continued)

– 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 grantor trust rules contain precise rules for determining who the transferor (grantor) is in the above example. The Beneficiary is treated as the grantor to the extent of any gratuitous transfer to the Beneficiary Grantor Trust, 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. However, these rules may not apply for transfer tax purposes.
- 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 Beneficiary Grantor Trust. 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.

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Considerations of the Technique (Continued)

- 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 be "a bona fide sale". In the family partnership context, courts have held that to be a bona fide sale the transfer of assets to the partnership must have a significant nontax purpose. Whether this requirement would apply to a sale to a Beneficiary Grantor Trust, and what it would mean in that context, are uncertain.
- 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, is the IRS barred upon the Beneficiary's death from asserting inadequacy of consideration for purposes of IRC Sec. 2036 and 2038?
- The answer may be yes, but is uncertain. Adequacy of consideration is a "valuation issue" rather than a "legal issue." Treas. Reg. §25.2504-2(c), Ex. (3).
- Creditor considerations, which could lead to estate tax issues.
- Creditor considerations, which could lead to gift tax issues.

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Considerations of the Technique (Continued)

- Income tax issues:
  - In general:
    - The Beneficiary Grantor Trust must remain a grantor trust to the transferor during the transferor'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."

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Considerations of the Technique (Continued)

- Release vs. lapse:
  - One issue with respect to any Beneficiary Grantor Trust 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 recent non-precedential private rulings, 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). 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). See Private Letter Rulings 200949012 and 201039010.
  - 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.
  - 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.

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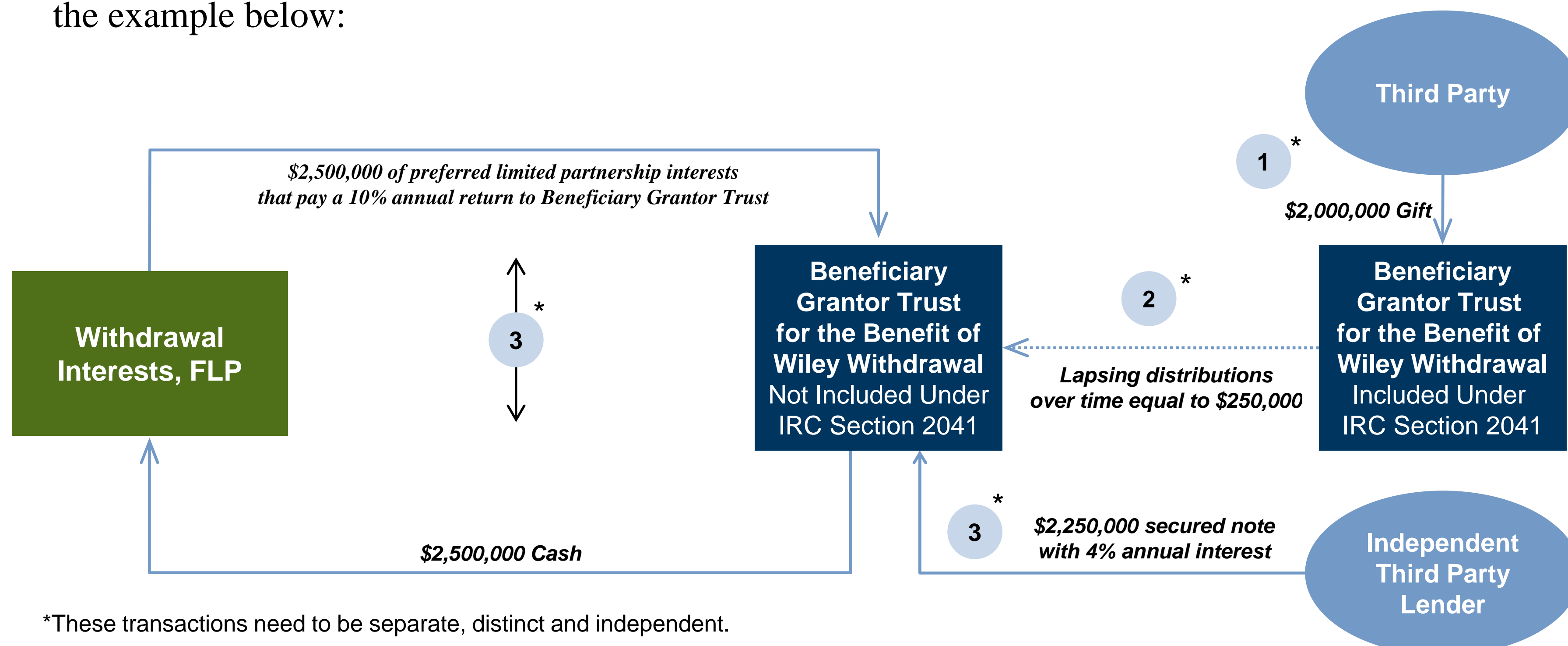
- The settlor to a Beneficiary Grantor Trust could contribute a corpus that is much greater than $5,000. The Beneficiary Grantor Trust could be designed so that the original unlimited power to withdraw all of the assets of the trust gradually lapses over time pursuant to a so-called "hanging power."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



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

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Advantages of the Technique

- A high yielding preferred partnership interest may make excellent collateral to an independent third party lender.
- Any future sales into the trust in which Wiley Withdrawal has a limited power of withdrawal may 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.
- 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 the trust, greater equity will exist in the trust. This equity could support subordinated note sales of other assets (e.g., preferred partnership interests) by Wiley.
- All of this could be done without the necessity of guarantee fees or sales of remainder interests in GRATs. There may be much more substance to the leverage of this technique than the other Beneficiary Grantor Trust techniques discussed.

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Considerations of the Technique

- Use of a Beneficiary Grantor Trust raises many of the income tax issues that are discussed above.
- If Wiley should die in the early years of the trust, a substantial portion of the original trust, which is subject to 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.
- This technique also requires 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.
- Pecuniary withdrawal right Issues:
  - The above use of the Beneficiary Grantor Trust, 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".
  - 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.

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Considerations of the Technique (Continued)

- 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 Beneficiary Grantor Trust is no longer wholly a grantor trust.
- 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.
- 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. 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.

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A Beneficiary Grantor Trust Purchases the Remainder Interest in a GRAT (Pages 159 – 164 of the Paper)

Example 23, Hypothetical Technique 10: Creation of a Leveraged GRAT in Which the Remainderman Pays Full Consideration For That Remainder Interest, is illustrated below

4 *
Beneficiary Grantor Trust Pays Betsy Bossdaughter $4,000 to Create GRAT

1 *
Sally Selfmade gifts $5,000

Contributes Assets

2 *

Receives 1.0% GP and 94.0% LP Interests

FLP
$85,000,000 in Assets

5% LP Interest

Bob Bossdaughter

Beneficiary Grantor Trust
for Betsy Bossdaughter and Family

Betsy Bossdaughter

Contributes and Sells $2,000,000 in Financial Assets and 94% LP Interests

FLLC
$2,000,000 in Assets
94% LP Interests

Contributes 99.0% Non-Managing Member Interests

3-Year GRAT
($4,000 Defined Formula Remainder Value)

5
At termination of GRAT the FLLC interests pass to the Beneficiary Grantor Trust

3 *
Receives 100% Managing Member and Non-Managing Member Interests and $52,000,000 in Three Year Notes That pay .21% Interest

4 *
Grantor Receives $1,377,436 Annual Annuity Payments for 3 Years

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

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Advantages of the Technique

- The assets of the Beneficiary Grantor Trust, if Betsy is not a transferor, or a deemed transferor under equitable principles, will not be subject to estate taxes in Betsy’s estate.
- Circumvents capital gains tax consequences on the sale of assets to the trust.
- Has the advantage of allowing Betsy access to cash flow from note payments, and as a beneficiary of the Beneficiary Grantor Trust.
- Betsy also has flexibility to change the future beneficiaries of the trust through the exercise of a special power of appointment.
- Has the potential of mitigating gift tax surprises.
- Appreciation will be out of the Betsy's estate.

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Advantages of the Technique (Continued)

- Obviously, if this technique survives *substance over form, step transaction and other potential attacks by the IRS*, it could be a very powerful technique with respect to estate planning for Betsy Bossdaughter and her family. It may be more prudent to have a more substantive remainder interest (e.g., by using a spousal grantor trust as the remainderman). Please see the following table, which denotes what the estate taxes would be at the end of five years, 15 years and 30 years. See the table below:

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
Hypothetical Technique #10: 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)	$25,981,336	$17,882,519	$0

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Considerations of the Technique

- 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. It is also important that accurate valuations be obtained. Consider using only easy to value assets or proportional interests in the same entity.
- Need to file a federal gift tax return.
- State income tax considerations.
- Step transaction doctrine could apply.
- Creditor considerations.
- It is necessary for the settlor to steer clear of grantor trust status.
- IRC Sec. 678 issues.

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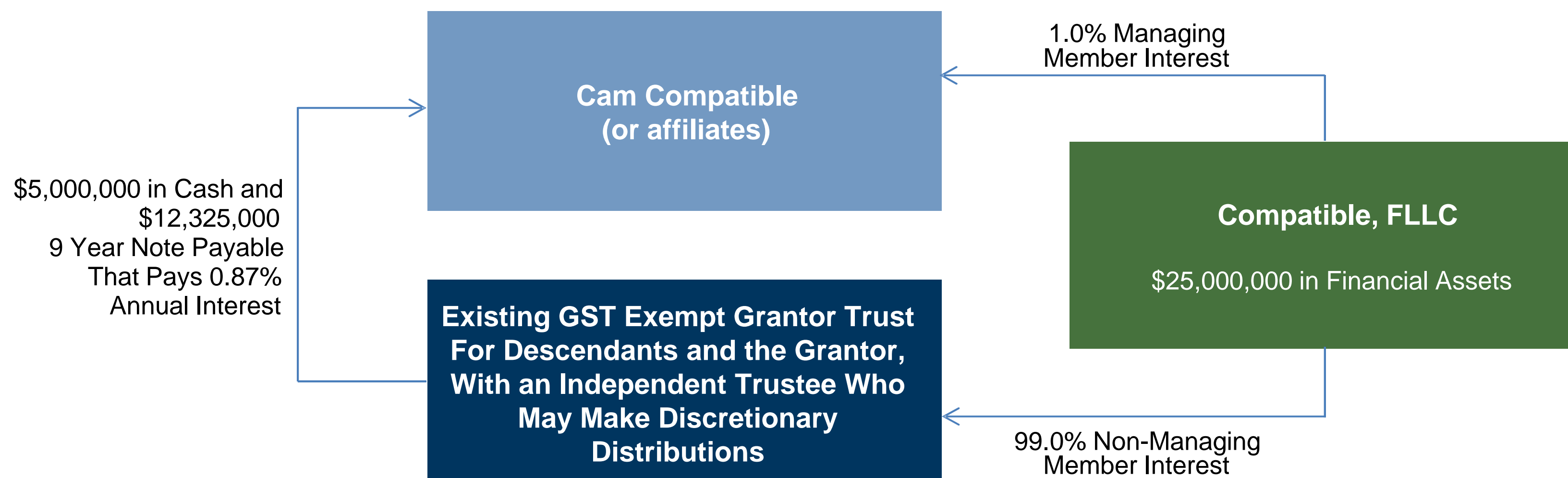
Example 24, Hypothetical Technique 11: Gift or Sale of Assets to a Grantor Trust in Which the Grantor is Also a Discretionary Beneficiary

Cam Compatible made a gift of $5,000,000 in financial assets to a generation-skipping trust that was also a grantor trust. In the following year, in an independent transaction, Cam formed a FLLC that had managing and non-managing interests. Cam contributed $25,000,000 in financial assets to that FLLC. Cam then sold the non-managing interests in that FLLC in consideration for $5,000,000 in cash and a $12,325,000 nine year note that paid 0.87% interest (the then AFR rate). Cam's annual consumption needs are equal to $250,000. It is assumed those consumption needs and the estate tax exemption will increase 3.0% a year, which is the assumed inflation rate.

The transaction that Cam entered into is illustrated below:



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Advantages of the Self-Settled Trust Technique

- Tax advantages of creating a grantor trust and a sale to grantor trust.
- The near term death of the grantor of a grantor trust generally does not affect the technique's life at death of a grantor of a GRAT.
- The appreciation of the assets above the interest of the note used in any sale to a grantor trust will not be taxable in the grantor/seller's estate.
- Flexibility advantages of selling to grantor trust in which the seller is a discretionary beneficiary.
- Flexibility could also be achieved by converting the note with a different interest rate, a private annuity, purchasing assets owned by the trust and/or renaming the powers that make the trust a grantor trust.

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Considerations of the Self-Settled Trust Technique

- There may need to be substantive equity in the trust from prior gifts (is 10% equity enough?) before the sale is made.
- State income tax considerations.
- The IRS could be successful in applying the step transaction doctrine to the technique.
- If the assets decrease in value, the gift tax exemption equivalent may not be recoverable.
- There may be capital gains consequences with respect to the notes receivables and/or payables that may exist at death.
- 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.
- Creditor considerations, which could lead to estate tax issues.
- Creditor considerations, which could lead to incomplete gift issues.
- To get the benefit of the laws of an asset protective jurisdiction for a grantor/beneficiary who does not live in such a jurisdiction, trustee fees will be incurred, and if there is a co-fiduciary in another jurisdiction, the creditor protection may not exist.

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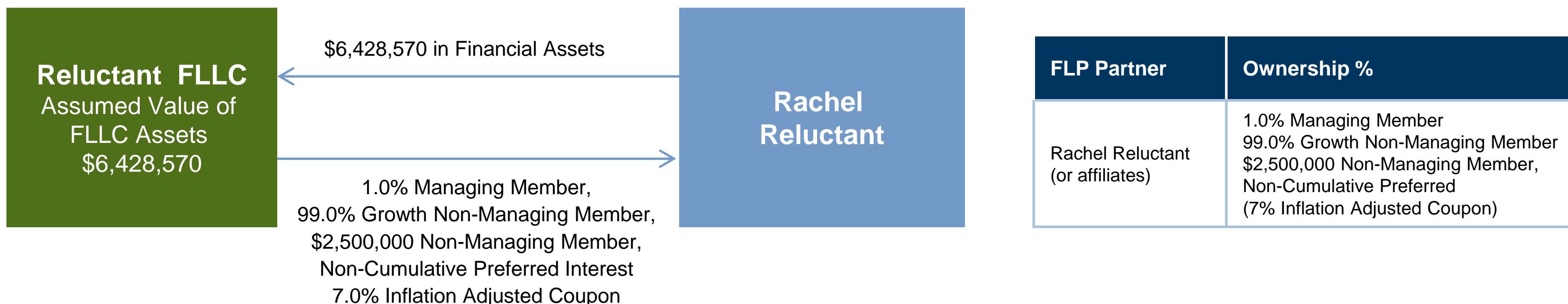
Example 25, Hypothetical Technique 12: Rachael Reluctant Creates a FLLC and Retains Preferred Interest That Does Not Have Any Value For Gift Tax Purposes

Rachael Reluctant owns $12,000,000 in financial assets. Rachael has a 15-year life expectancy. Over that 15-year period, she expects to spend $300,000 a year, before income taxes, and she expects that her assets will have approximately an annual 7% rate of return, pre-tax. Rachael 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. Rachael does not wish to pay any estate or gift taxes on her wealth and she wishes for most of her estate to pass to a generation-skipping trust.

In the past, Rachael 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. Rachael 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. Rachael would also like to obtain, as much as possible, a step-up in basis on her appreciated assets at her death.

Rachael's current attorney, Fred Freeze, suggests that she contribute a little over one-half of her assets to a FLLC in consideration for a flexible non-cumulative preferred whose non-cumulative coupon grows with inflation and growth interests. This technique is illustrated below:



FLP Partner	Ownership %
Rachel Reluctant (or affiliates)	1.0% Managing Member 99.0% Growth Non-Managing Member $2,500,000 Non-Managing Member, Non-Cumulative Preferred (7% Inflation Adjusted Coupon)

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Transferor Creates a FLP or a FLLC With Flexible Preferred Interests and Retains Those Preferred Interests, Even if the Design of the Preferred Interests Deliberately Violates the Gift Tax Valuation Rules of IRC Sec. 2701 (Continued)

- 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, Rachael will be considered to have made a $5,250,000 gift, for gift tax purposes, when she gifts the growth interest ($2,500,000 preferred plus a growth interest valued at $2,750,000) 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 "extra gift" caused by the gift tax valuation rules will be mitigated by subtracting the amount of that "extra gift" from the value of the preferred that is subject to estate taxes at Rachael's death. See IRC Treas. Reg. § 25.2701-5(a)(3).
- Rachael will have made a transfer valued at $2,750,000 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 $2,750,000 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 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".

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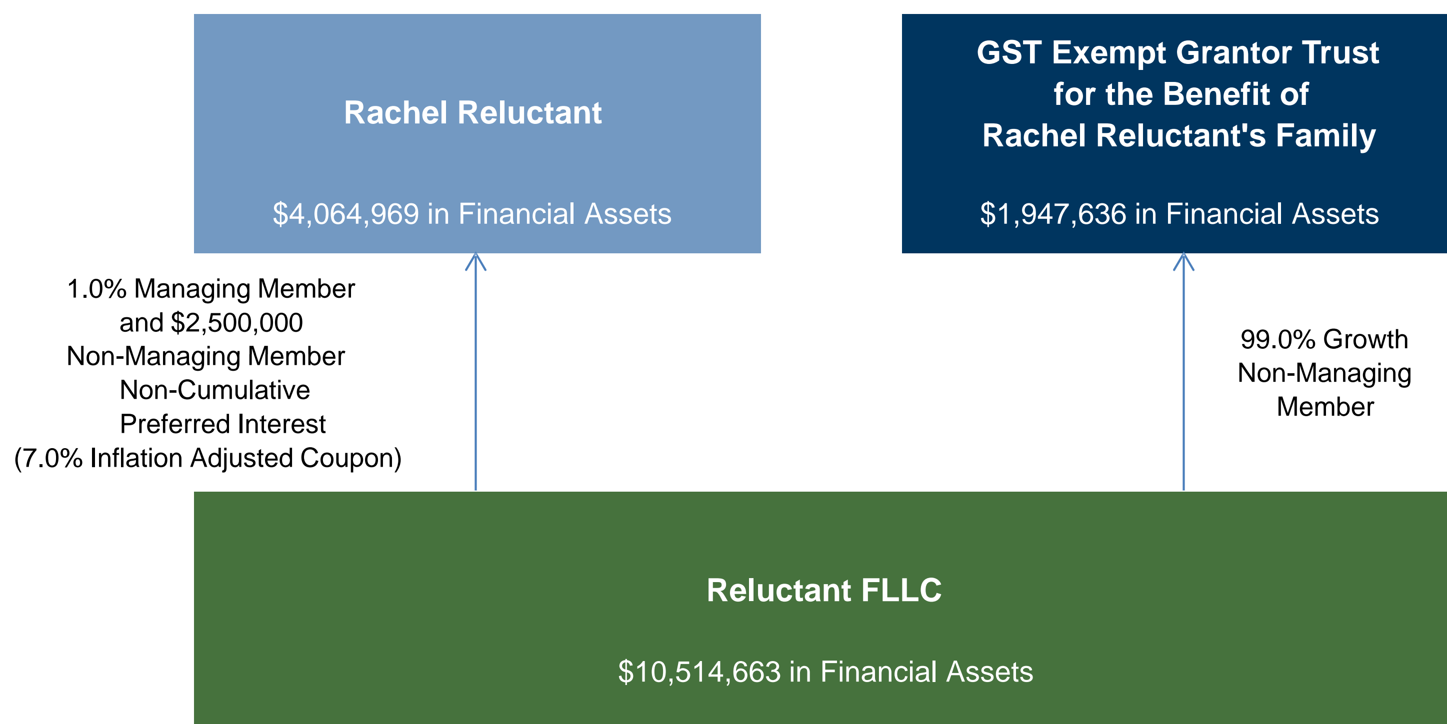
- In 15 years, at the time of Rachael's death, under the above assumptions, Rachael's balance sheet and the family FLLC balance sheet will be as illustrated on the slide below:



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Transferor Creates a FLP or a FLLC With Flexible Preferred Interests and Retains Those Preferred Interests, Even if the Design of the Preferred Interests Deliberately Violates the Gift Tax Valuation Rules of IRC Sec. 2701 (Continued)

- Despite the fact that Rachael has available the cash flow from almost all of her assets, and those assets have a value more than two times the available transfer tax exemption when she initiated the estate plan, the technique is very effective in avoiding estate and gift taxes. Most of her wealth will pass to a generation-skipping trust, there will not be any gift tax, there will be a step up in basis on around $6,600,000 of the assets, and the estate tax will be relatively small. See the table below:

	Reluctant Children	Reluctant Children and Grandchildren	Consumption Direct Cost	Consumption Investment Opportunity Cost	IRS Income Tax	IRS Investment Opportunity Cost	Estate Taxes (@ 40%)	Total
	Total to All Descendants							
15-Year Future Values								
No Further Planning: Bequeaths Estate to Family (assumes $8.18mm estate tax exemption available at death)	$5,223,365	$8,180,000	$5,579,674	$3,428,307	$4,466,354	$2,748,435	$3,482,243	$33,108,378
	$13,403,365							
Hypothetical Technique 12: Creation of a FLLC; Gift of Growth Non-Managing Member Interests to a GST Exempt Grantor Trust; Bequeaths Estate to Family; $2.5mm Non-Managing Member Non-Cumulative Preferred Not Taxed in Estate (assumes $5.43mm estate tax exemption available at death which includes an additional $2.5mm mitigation of preferred)	$744,070	$15,287,152	$5,579,674	$3,428,307	$4,824,695	$2,748,435	$496,046	$33,108,378
	$16,031,222							
Present Value (discounted at 3%)								
No Further Planning: Bequeaths Estate to Family (assumes $8.18mm estate tax exemption available at death)	$3,352,679	$5,250,431	$3,581,381	$2,200,500	$2,866,783	$1,764,116	$2,235,120	$21,251,008
	$8,603,110							
Hypothetical Technique 12 Creation of a FLLC; Gift of Growth Non-Managing Member Interests to a GST Exempt Grantor Trust; Bequeaths Estate to Family; $2.5mm Non-Managing Member Non-Cumulative Preferred Not Taxed in Estate (assumes $5.43mm estate tax exemption available at death which includes an additional $2.5mm mitigation of preferred)	$477,590	$9,812,241	$3,581,381	$2,200,500	$3,096,788	$1,764,116	$318,393	$21,251,008
	$10,289,831							

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Advantages of the Intentionally Defective Preferred Interest Technique

- Tax advantages of creating a grantor trust and tax advantages similar to a sale to a grantor trust.
- The near term death of the grantor of a grantor trust generally does not effect the technique like the death of a grantor of a GRAT.
- The appreciation of the assets of the trust above the preferred coupon will not be taxable in the grantor's estate.
- IRC Sec. 2036 advantage.
- Flexibility advantages.
- Basis advantages.
- The capital gains consequences that may exist for existing note receivables and/or payables does not exist at death with this technique.
- The technique could work in much larger situations through the use of a debt sale or a loan to the entity.

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Considerations of the Intentionally Defective Preferred Interest Technique

- There needs to be enough substantive equity in the growth interest in the entity.
- The IRS could be successful in applying the step transaction doctrine to the technique.
- If the assets of the entity decrease in value, the gift tax exemption equivalent may not be recoverable.
- The IRS may contest the valuation of the growth interests that are donated to the grantor trust.

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Conventional Wisdom:

- "Using a preferred partnership interest is dead after the passage of IRC Sec. 2701;" or
- "It is impossible, after split dollar reform, without paying significant gift taxes, for a trust to have the means to pay for premiums on a significant life insurance policy."

This "conventional wisdom," under the circumstances discussed below, may be incorrect.

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- One of the somewhat unexplored areas of estate planning is the utilization of what some practitioners call "reverse freeze" planning. This planning takes advantage of the truism that investors have the potential of making a successful investment, if they engage in a leveraged purchase of a high yield preferred interest. The following idea exploits the current differentiation in yields between high yield fixed income and treasuries.

- Consider the following example, which illustrates the potential of combining a leveraged sale of a high yielding preferred to a grantor trust with the trust using its excess cash flow to purchase life insurance and make cascading purchases of the growth partnership interests:

Partner	Ownership (%)
Ian & Inez Insurance	0.5% GP; 99.5% Growth LP; $30mm Preferred LP

- After the partnership has been created Ian and Inez Insurance transfers, by gift, a $3,000,000 preferred partnership interest with a non-cumulative 10.5% coupon to some generation-skipping transfer trusts for the benefit of their children, grandchildren and future descendants.

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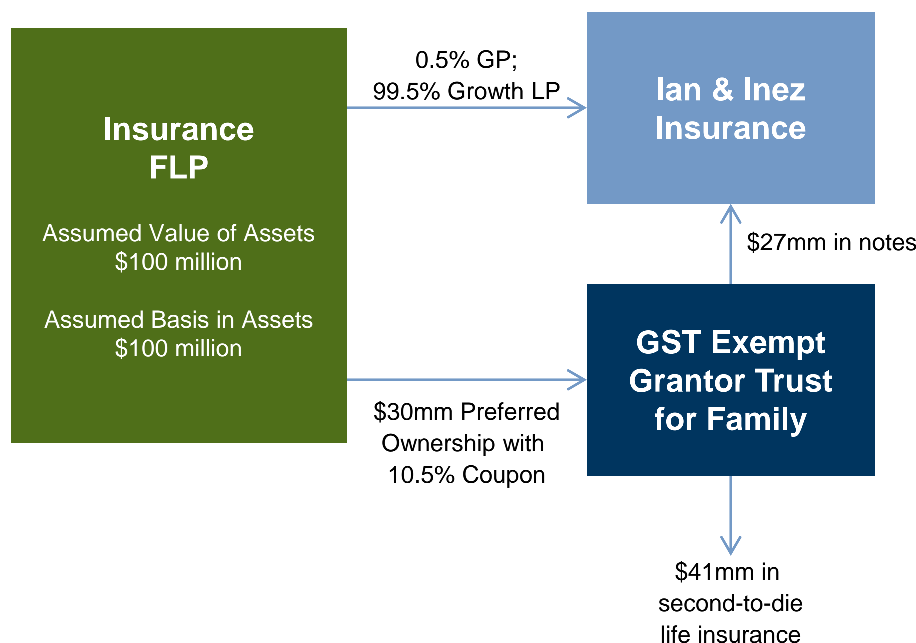
- Ian and Inez also sell the remaining $27,000,000 preferred interests to those trusts in exchange for notes that will pay a blended AFR rate of 0.87%.

  See the illustration below:



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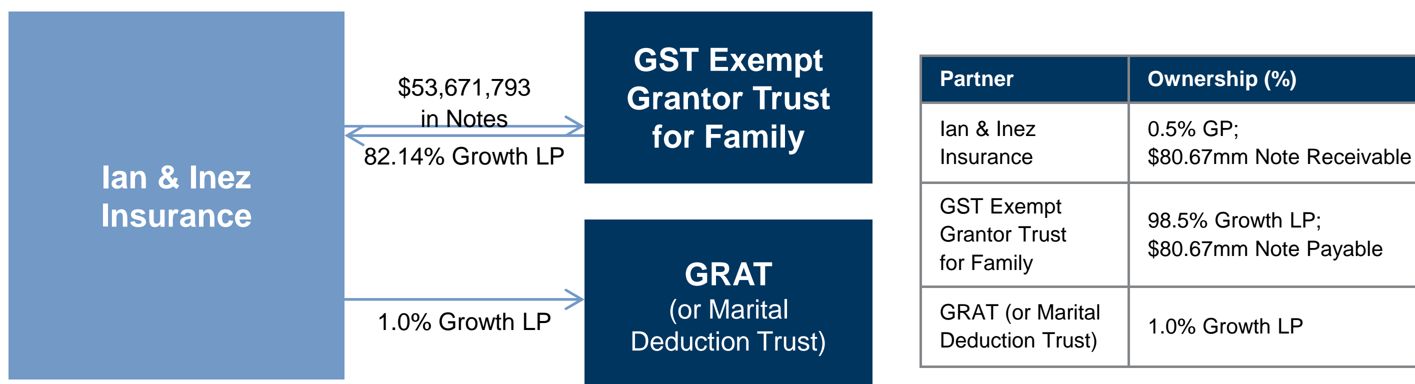
- Approximately three years after the transfer of the preferred partnership interests, the GST grantor trust could purchase from Ian and Inez their remaining growth interests that have not been sold in prior years in exchange for notes (on which, it is again assumed there will be a blended 2.06% interest rate).
- During the interim three year period, it is assumed that around 16% of the growth limited partnership interests will have been purchased. The purchase of the remaining growth interests could occur in a manner in which there is a defined value sale and in which a stated dollar amount (around $54M) of the value of the transferred growth limited partnership interest, as finally determined for federal gift tax purposes, passes to the generation-skipping trusts and any excess in value passes to a near zero GRAT or a marital deduction trust.
- See the illustration below:



Partner	Ownership (%)
Ian & Inez Insurance	0.5% GP; $80.67mm Note Receivable
GST Exempt Grantor Trust for Family	98.5% Growth LP; $80.67mm Note Payable
GRAT (or Marital Deduction Trust)	1.0% Growth LP

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Use of the Leveraged Reverse Freeze to Pay For Life Insurance and Cascading Purchases of Growth FLP Interests (Continued)

- Advantages:
  - With the use of life insurance, there is a hedge against early deaths.
  - In Revenue Ruling 83-120 the IRS concedes preferred partnership interests in a closely held partnership should have a high coupon.
  - Currently, there exists a significant arbitrage between high yielding private preferred partnership interests in a closely held partnership and treasury interest rates.
  - Strong legislative history suggests IRC Sec. 2036 should not apply to partnerships with significant preferred interests.
  - The valuation rules of IRC Sec. 2701 should not apply if one generation transfers its ownership of preferred partnership interests to the second generation.
  - A later transfer of the growth partnership interests will not be affected by the valuation rules of IRC Sec. 2701.

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- The tables below indicate the results that could accrue under the assumptions given to Pam Planner by Ian and Inez and also assuming a $400,000 a year premium and a 40% discount on the growth partnership interests (because of the effect of the preferred partnership interests). The results are extremely powerful. Assuming that Ian and Inez die in 10 years, the 30 year future values of the hypothetical integrated plan in comparison to not doing any further planning is as follows:

30 Year Future Values (Death in 10 Years)

Hypothetical Techniques	Insurance Children	Insurance Children & Grandchildren	Consumption Direct Cost	Consumption Investment Opportunity Cost	IRS Income Tax	IRS Investment Opportunity Cost	IRS Estate Tax (at 40%)	Investment Opportunity Cost/(Benefit) of Buying Life Insurance	Total
30 Year Future Values (Death in 10 Years)									
No Further Planning; Bequeaths Estate to Family (assumes $14.1mm estate tax exemption available)	$225,689,299	$0	$22,927,759	$97,658,377	$91,990,591	$295,649,733	$50,146,512	$0	$784,062,269
Hypothetical Technique #13: Bequeaths Estate to Family (assumes $14.1mm estate tax exemption available)	$100,174,771	$291,214,944	$22,927,759	$97,658,377	$145,306,217	$247,024,872	$17,026,275	($137,270,945)	$784,062,269

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- If the survivor of Ian and Inez Insurance dies in 30 years, the future value in 30 years of what their descendants will receive under the hypothetical plan in comparison to no further planning is as follows:

Future Value (Death in 30 Years)

Hypothetical Techniques	Insurance Children	Insurance Children & Grandchildren	Consumption Direct Cost	Consumption Investment Opportunity Cost	IRS Income Tax	IRS Investment Opportunity Cost	IRS Estate Tax (at 40%)	Investment Opportunity Cost/(Benefit) of Buying Life Insurance	Total
30 Year Future Values (Death in 30 Years)									
No Further Planning; Bequeaths Estate to Family (assumes $25.5mm estate tax exemption available)	$153,752,429	$0	$95,150,831	$164,098,797	$105,165,355	$180,384,074	$85,510,782	$0	$784,062,269
Hypothetical Technique #13 Bequeaths Estate to Family (assumes $25.5mm estate tax exemption available)	$2,318,772	$245,735,327	$95,150,831	$164,098,797	$105,211,327	$174,762,900	$0	($3,215,685)	$784,062,269

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Leveraged Reverse Freeze With a GRAT

- What would be the comparative outcome under the proposed structure if long term GRATs were used?
  - If Mr. and Mrs. Insurance create GRATs that last 10 years with a 10.5% preferred coupon that supports "par value" for the preferred, the gift will be $905,120.50, assuming the IRC Sec. 7520 rate is 1%, even though trusts for their children will receive $30,000,000 of preferred partnership interests at the end of 10 years.
  - If the term of the GRAT is 11 years, assuming the IRC Sec. 7520 rate is 1%, the gift will be $170,000.
  - If the appraisers find that the rate of return on the preferred interests should be equal to 11.60375% in order to support par value of the preferred interests, and the 10 year GRATs are created with $30,000,000 of preferred interest paying all of that coupon in satisfaction of the retained annuity, the GRATs will be near zeroed out GRATs.
  - Thus, in each of these scenarios, Mr. and Mrs. Insurance could be in the position to receive substantial cash flows for a 10 year or 11 year period, and assuming the gift tax exemption that they each have is $450,000, they will each transfer preferred interests that are equal in value to over $30,000,000 to trusts for the benefit of their children by paying little or no gift taxes.
  - All of this is accomplished, even though their investment portfolio could earn 4% to 5% annually, after taxes.

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Conventional Wisdom:

- "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.

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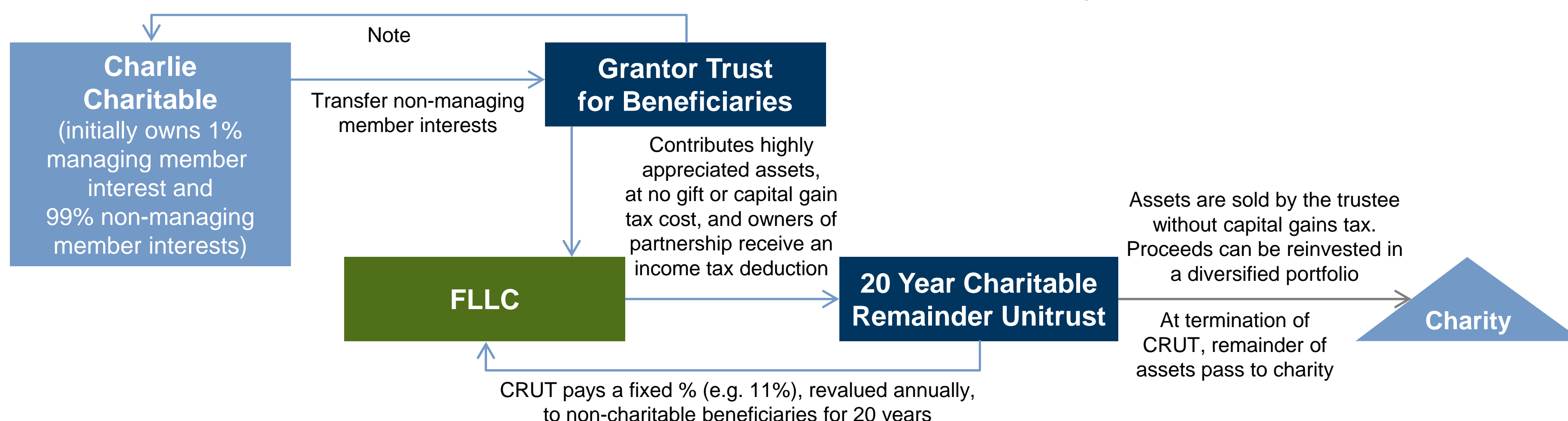
Example 27, Hypothetical Technique 14: Charlie Charitable Wishes to Benefit His Family, His Charitable Causes and Himself With a Monetization Strategy

Charlie Charitable's Attorney, Pam Planner Shows Charlie the Following Plan:



Advantages	Considerations
• Generation of current income tax deduction (10% or more of value placed in CRUT) • Depending on investment performance, approximately 40% to 60% of inherent capital gains in the asset contributed to the CRUT will not be subject to capital gains tax • The remaining inherent capital gains will be subject to tax, but is tax-deferred (over 20 years) • Production of relatively steady cash flow over time • Tax-efficient satisfaction of charitable desires • Economic participation in growth of assets	• Limit on certain investment alternatives • Certain prohibited related-party transactions (even if fair) • In the early years, access to capital is limited • Capital gains tax rates may increase in the future • Administrative costs in connection with formation of partnership

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Use of a Leveraged and Discounted Sale of the Non-Charitable Interest in a CRUT to a Grantor Trust (Continued)

- The use of a leveraged and discounted sales of the non-charitable interest in a CRUT to a grantor trust incorporates powerful synergies:
  - The tax advantage of creating a grantor trust and a sale to a grantor trust.
  - The tax advantage of using leverage.
  - The tax advantage of lowering opportunity costs by delaying taxes
  - The tax advantage of allocating tax liabilities to the donor and layering tax effects.
  - The tax advantage of integration.
- 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, sale of limited liability company or limited partnership interests to a grantor trust. What if that synergistic planning simulated a capital gains tax and estate tax holiday for the client and his family with the client's family charity receiving 21% of his death on his death?

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The Comparative Results

- 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 sold partnership interests to a grantor trust without including the CRUT component. Some of Pam's key assumptions are as follows: the valuation discount of the partnership is 35%, the pre-tax investment return is 8% and that Charlie, under the charitable plan, will bequeath his estate to charity. If the investment plan produced smooth returns until Charlie's death (which the group agrees to project twenty-five years into the future), the results would look like this:

Hypothetical Technique #17 (Assumes $11.0mm Estate Tax Exemption Available)	Charlie's Children	Charlie's Descendants (GST Exempt)	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
Stock Sale, No Planning	$3,137,833	10,992,334	$0	$5,468,890	$7,032,316	$10,988,045	$20,803,380	$5,023,178	$63,445,974
Simulated Tax Holiday (No Initial Capital Gains Tax and No Estate Tax) 79% - 21% Split Between Family and Charity	$0	$24,883,319	$6,496,960	$5,468,890	$7,032,316	$10,825,721	$13,135,703	$0	$67,842,908
FLP/CRUT/Grantor Trust Sale, Charlie gives remaining estate to charity	$0	$22,772,039	$6,496,960	$5,468,890	$7,032,316	$11,532,839	$14,539,861	$0	$67,842,905
FLP/Grantor Trust Sale, Charlie gives remaining estate to family	$0	$22,592,172	$0	$5,468,890	$7,032,316	$11,613,571	$20,803,380	$0	$67,510,326

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Conventional Wisdom:

- "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.

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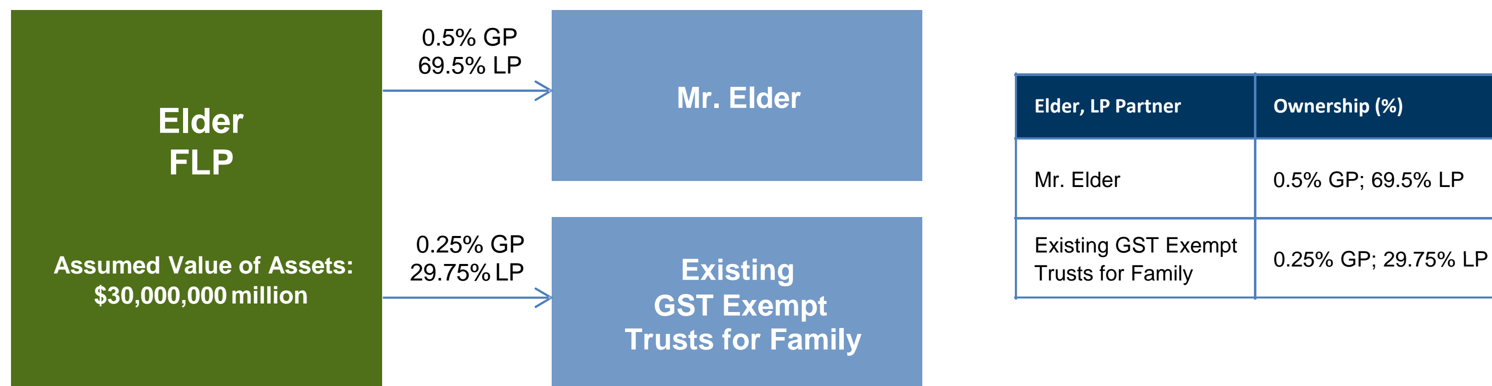
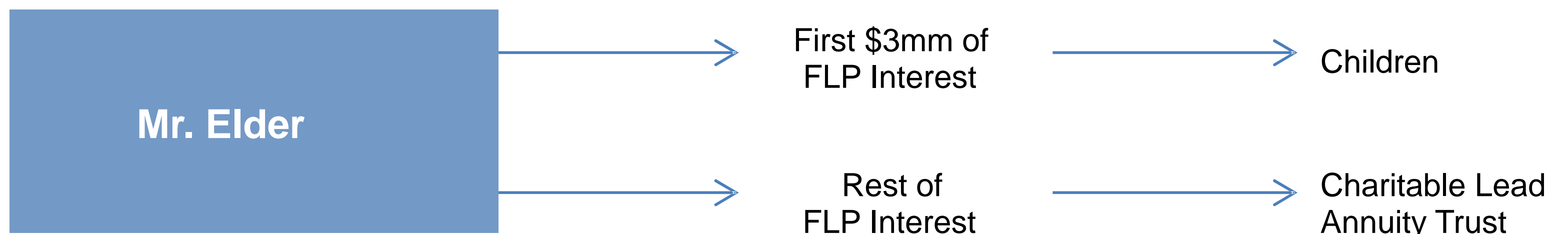
Use of a Leveraged Buy-Out of a CLAT (Continued)

- 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 testamentary CLAT. Two of the key assumptions are that the IRC Sec. 7520 rate is 1% and that the partnership valuation discount is 40%.
  - During Ed's lifetime he creates a partnership 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 partnership interest as follows:



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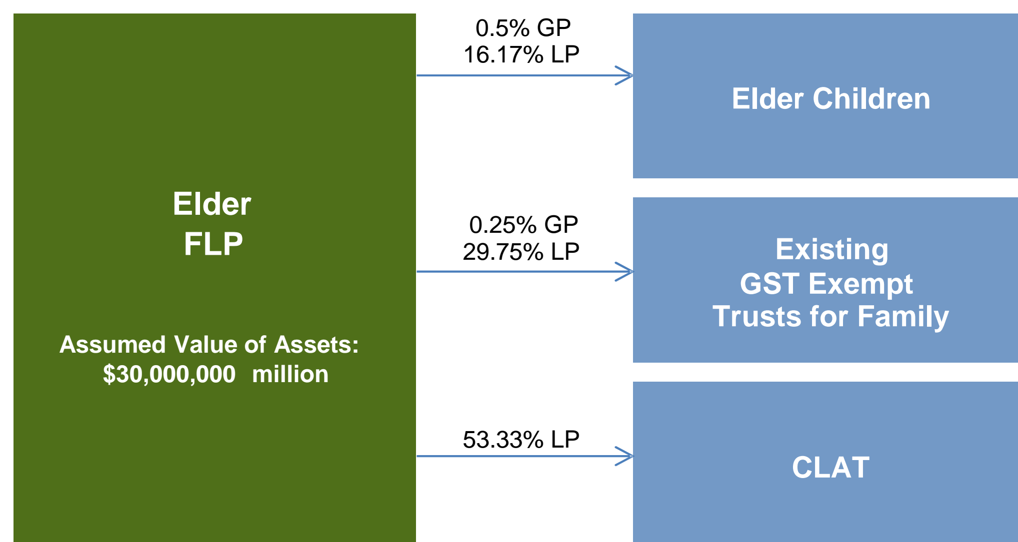
Use of a Leveraged Buy-Out of a CLAT (Continued)

– The percentage ownership of Elder Family Limited Partnership before any redemptions pursuant to a probate court hearing is as follows:



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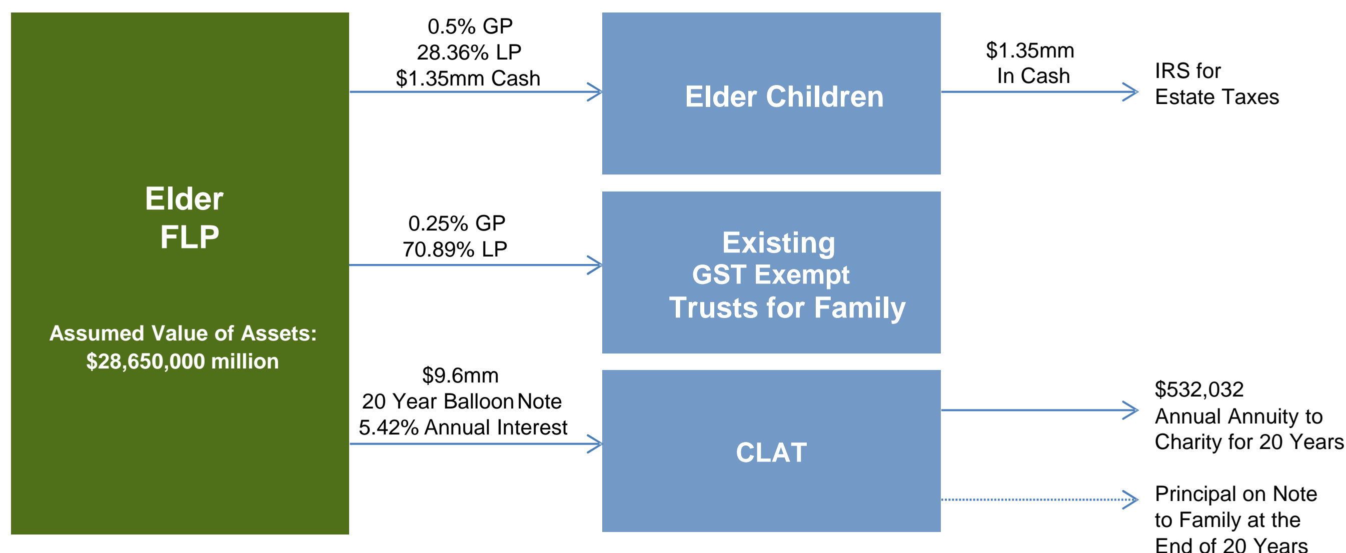
Use of a Leveraged Buy-Out of a CLAT (Continued)

– After a probate court hearing the children's interest is partially redeemed and the CLAT's interest is totally redeemed as follows:



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What Are the Comparative Results of the Leveraged Buy-Out CLAT?

Summary of Results in 30 Years For $30 Million of Assets Growing at 7% Per Year (Pre Tax) – No Further Planning vs. 20 Year Testamentary CLAT Technique; 30 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	$61,669,543	$53,664,987	$0	$40,236,839	$137,308,338	$9,000,000	$301,879,707
No Further Planning - Discount Allowed	$79,933,715	$53,664,987	$0	$46,491,600	$116,389,405	$5,400,000	$301,879,707
Hypothetical Technique #15a - CLAT Redemption Discount Allowed - $3 Million to Family	$51,066,322	$84,604,627	$52,562,979	$43,416,676	$68,879,103	$1,350,000	$301,879,707
Hypothetical Technique #15b - CLAT Redemption Discount Allowed - $10 Million to Family	$78,470,827	$54,690,286	$14,235,807	$45,316,751	$104,666,036	$4,500,000	$301,879,707

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What Are the Comparative Results of the Leveraged Buy-Out CLAT (Continued)?

- 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 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 partnership are also receiving an income tax deduction on the interest payments.
- The secondary 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 the family's perspective, the principal of the note is, in effect, paid to themselves.
- From the family's perspective, they have the assets now subject to the interest obligations of the note held by the CLAT (which could be satisfied with a sinking fund of laddered bonds).

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Example 29, Hypothetical Technique 16: Gift of a Preferred FLLC Interest

George Generous is unhappy about some of the income and healthcare tax limitations associated with traditional charitable giving. 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 a deduction this year for 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 tax on the projected sale of his appreciated assets.

Pam Planner suggests that George consider forming a 50-year term FLLC that is structured to have both preferred and growth interests. George could contribute most of his assets to the FLLC. For instance, George could contribute his assets to the FLLC and receive a preferred interest that pays a coupon of 7%. The single member FLLC would be created in a manner in which George receives his preferred interest in consideration of his contribution of his most appreciated assets. The rest of his member interests would receive any income or gains above what is necessary to fund the preferred coupon.

After the FLLC is formed, Pam suggest that George make a gift of the preferred FLLC member interest to his favorite charity, the Doing Good Donor Advised Fund (which is a qualified public charity). The Doing Good Donor Advised Fund is entitled to an 7% preferred coupon each year.

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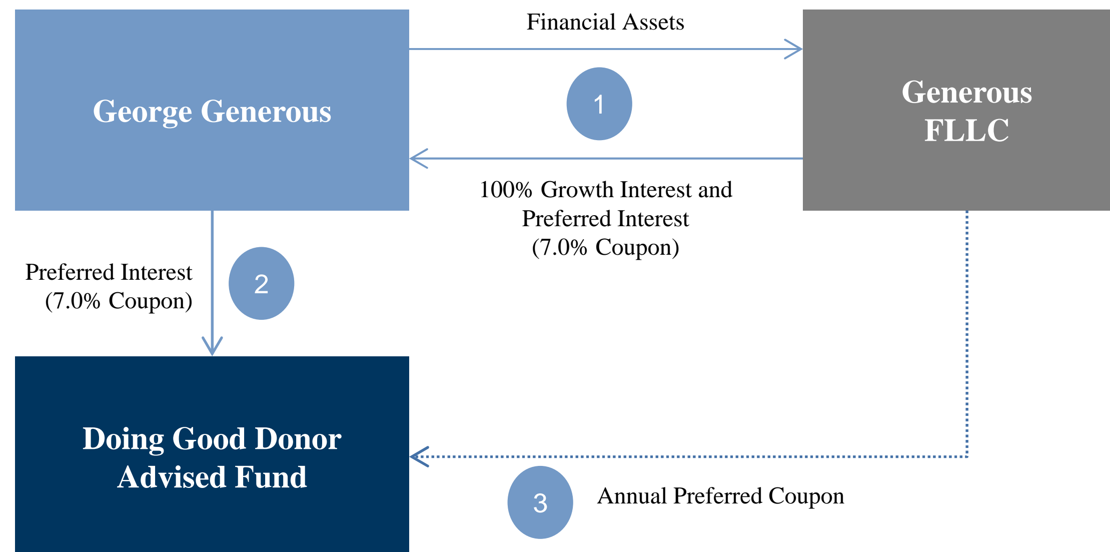
Synergy of Using Preferred FLP or FLLC Interests With Charitable Planning: Significant Income Tax and Healthcare Tax Savings Associated With Gifting a Preferred FLLC Interest to a Public Charity (Continued)

This technique ("Hypothetical Technique 16") is illustrated below:



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- In order to isolate the benefits of each of the annual giving strategies, it is assumed that George's assets will earn 7% before taxes. Using those assumptions the tax efficiency ratio (present value of both total net tax savings divided by the present value of the total out of pocket cash) is calculated under various assumed scenarios. Under the Version 1 scenario, in the table below, it is assumed a "0" asset basis is sold to fund the income needed for the annual charitable giving. The Version 2 scenarios below assume a "full" basis asset is sold to fund the income needed for the annual charitable giving. The "a" versions below assume the preferred technique is not used and out of the pocket cash gifts are made. The "b" versions below assume the preferred interest technique is used and the 7% preferred coupon carries out a 3% ordinary income payment. The "c" versions below assume the preferred interest technique is used and the 7% preferred coupon carries out a 7% ordinary income payment to the charity and a "0" long term capital gains payment.

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- Please see the table below:

	Description	Tax Efficiency Ratio (Present Value of Total Net Tax Savings ÷ Present Value of Total Out of Pocket Cash)
Version 1a	Sale of a "0" Basis Asset, Annual Cash Gift for Twenty Years of 7% of the Value of the Sale Proceeds that Remain After Paying Taxes Associated with the Sale, Bequest of the Remaining Sale Proceeds in Twenty Years to Charity	16.34%
Version 1b	Creation of a 7% Coupon Preferred FLLC Interest in Exchange for a "0" Basis Asset that is Sold After FLLC is Created and Gift is Made to a Public Charity; 3% of the Preferred Return is Taxed as Ordinary Income and 4% of the Preferred Return is Taxed as Capital Gains Income; FLLC Terminates in 20 Years	94.59%
Version 1c	Creation of a 7% Coupon Preferred FLLC Interest in Exchange for a "0" Basis Asset that is Sold After FLLC is Created and Gift is Made to a Public Charity; All Income from Preferred Coupon is Taxed as Ordinary Income; FLLC Terminates in 20 Years	102.90%
Version 2a	Sale of a Full Basis Asset, Annual Cash Gift for Twenty Years of 7% of the Value of the Sale Proceeds that Remain After Paying Taxes Associated with the Sale, Bequest of the Remaining Sale Proceeds in Twenty Years to Charity	39.70%
Version 2b	Creation of a 7% Coupon Preferred FLLC Interest in Exchange for a Full Basis Asset that is Sold After FLLC is Created and Gift is Made to a Public Charity; 3% of the Preferred Return is Taxed as Ordinary Income and 4% of the Preferred Return is Taxed as Capital Gains Income; FLLC Terminates in 20 Years	71.23%
Version 2c	Creation of a 7% Coupon Preferred FLLC Interest in Exchange for a Full Basis Asset that is Sold After FLLC is Created and Gift is Made to a Public Charity; All Income from Preferred Coupon is Taxed as Ordinary Income; FLLC Terminates in 20 Years	79.53%

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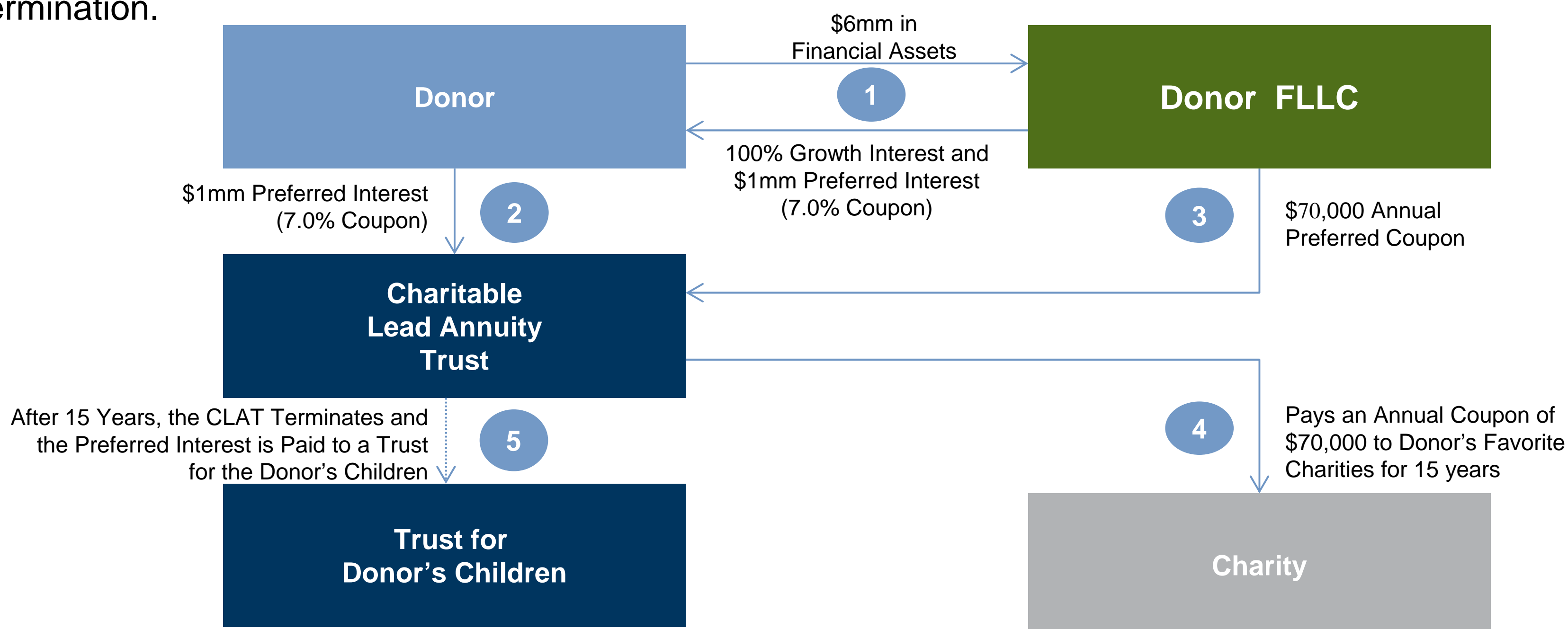
- What if a financial engineering technique existed that would generally ensure the financial success (from the remainderman's perspective) of a CLAT and would create additional discounts for any future non-charitable gifts?

- 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 the other 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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The Use of a High-Yield Preferred FLP or Membership Interests With A CLAT (Continued)

- Under the assumed facts of the above illustration, George will successfully transfer his preferred interest in 15 years to a trust for his children without using any gift tax exemption and George will not be taxed on the income allocated to the charity.
- The preferred partnership interest or limited liability interest appears to work very well with all varieties of CLATs including, level payment CLATs, back-loaded payment CLATs, grantor CLATs and non-grantor CLATs.
- The growth interest in the FLP or FLLC could be given or sold and additional estate planning benefits could accrue. Substantial valuation discounts may exist with respect to any growth interests that are donated or sold, because of the presence of the preferred interest.
- Focusing on the tax benefits of the preferred interest gift to a CLAT in comparison to a net gift of the preferred interest to a taxpayer's family (i.e., an outright gift of the preferred interest to the family, with the family members agreeing to pay the gif tax by selling part of the preferred to pay for the gift taxes), or a testamentary bequest to family consider the table on the following page:

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The Use of a High-Yield Preferred FLP or Membership Interest With A CLAT (Continued)

Private Wealth Management

Version	Description	Total Present Value Received by Family Net of Taxes	Total Present Value Received by Charity	Total Present Value for Family and Charity
		Assuming a 7% Present Value Discount		
Version 1a	Parents Hold on to Preferred Interest; 3% of the Preferred Return is Taxed as Ordinary Income and 4% of the Preferred Return is Taxed as Capital Gains Income; FLLC Terminates in 15 Years; Bequeaths Estate to Family	$565,314	$0	$565,314
Version 1b	Creation of 15 Year CLAT Using Preferred Interest; 3% of the Preferred Return is Taxed as Ordinary Income and 4% of the Preferred Return is Taxed as Capital Gains Income; FLLC Terminates in 15 Years	$362,446	$682,183	$1,044,629
Version 1c	Net Gift of Preferred to Family; Family Pays Gift Taxes by Selling Part of Preferred; 3% of the Preferred Return is Taxed as Ordinary Income and 4% of the Preferred Return is Taxed as Capital Gains Income; FLLC Terminates in 15 Years	$669,977	$0	$669,977
Version 2a	Parents Hold on to Preferred Interest; All Income from Preferred Coupon is Taxed as Ordinary Income; FLLC Terminates in 15 Years; Bequeaths Estate to Family	$533,465	$0	$533,465
Version 2b	Creation of 15 Year CLAT Using Preferred Interest; All Income from Preferred Coupon is Taxed as Ordinary Income; FLLC Terminates in 15 Years	$362,446	$682,183	$1,044,629
Version 2c	Net Gift of Preferred to Family; Family Pays Gift Taxes by Selling Part of Preferred; All Income from Preferred Coupon is Taxed as Ordinary Income; FLLP Terminates in 15 Years	$635,077	$0	$635,077

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Use of a 20% Annual Increasing Annuity GRAT and "Proportionality" and "Debt" Exception to IRC Sec. 2701 to Plan for Private Equity Fund Managers and Hedge Fund Managers (Pages 212 – 218 of the Paper)

- Private equity fund managers or hedge fund managers often participate in their funds in two different manners.
- The fund manager often invests in his managed fund along with other investors and receives the same return and rights that the other investors receive.
- Additionally, the fund manager also receives a right to "carried" interest from the fund that participates in the profits of the fund after a certain minimum amount of profits have been allocated to the investors.
- Many of these mangers would like to do estate planning solely on their "carried" interest because of its greater growth potential.

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- However, because managers have two different types of equity interests in their funds, and because they are in control of the funds, many worry that the special valuation rules of IRC Sec. 2701 may apply to any transfers of the "carried" interest and those valuation rules may be applied in a manner that is disadvantageous in comparison to the hypothetical willing buyer, willing seller standard that is normally applied for gift tax transfers.

Example 30, Hypothetical 17: Iam A. Carrier Engages
in Estate Planning With Respect to His Carried Interest

Iam A. Carrier is a private equity fund manager, along with his partners of a $1 billion private equity fund. Mr. Carrier is interested in estate planning with respect to certain of his interests in a private equity fund in which he invests and co-manages. Mr. Carrier owns a .2% investment interest in the $1 billion private equity fund. Mr. Carrier also has a 10% interest in the entity that owns the general partner of the private equity fund. The general partner is entitled to the "carried interest" as further described below.

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- The profits and cash flow of the private equity fund are to be divided as follows:
  - First, to the investment owners in proportion to their unreturned capital contributions until all capital contribution amounts have been returned.
  - Second, to the investment owners until they have received an 8% return on their unreturned capital contribution amounts. This 8% "preference" return is cumulative and compounds annually.
  - Third, to the carried interest owners until they have received distributions totaling 20% of the total profits of the private equity hedge fund on a cumulative basis.
  - Fourth, to the carried interest owners and the investment owners so that the carried interest owners receive 20% of the "residual" cash flow and profits and the remaining 80% of the "residual" cash flow and profits are allocated among the investment owners in proportion to their respective membership interests.
- There are many investment reasons for Mr. Carrier to create a FLLC to hold the carried interest before he engages in estate planning, including certain control aspects inherent with his other co-managers.

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- Mr. Carrier has asked his attorney, Connie Careful, to develop planning ideas based on the following assumptions about the growth of the private equity fund:

	Beginning of Year	Distributed Income	Unrealized Growth	End of Year
Year 1	1,000,000,000	20,000,000	101,353,392	1,101,353,392
Year 2	1,101,353,392	22,027,068	111,625,902	1,212,979,294
Year 3	1,212,979,294	24,259,586	122,939,566	1,335,918,860
Year 4	1,335,918,860	26,718,377	135,399,908	1,471,318,768
Year 5	1,471,318,768	29,426,375	149,123,148	1,620,441,915
Year 6	1,620,441,915	32,408,838	164,237,285	1,784,679,200
Year 7	1,784,679,200	35,693,584	180,883,290	1,965,562,490
Year 8	1,965,562,490	39,311,250	199,216,425	2,164,778,916

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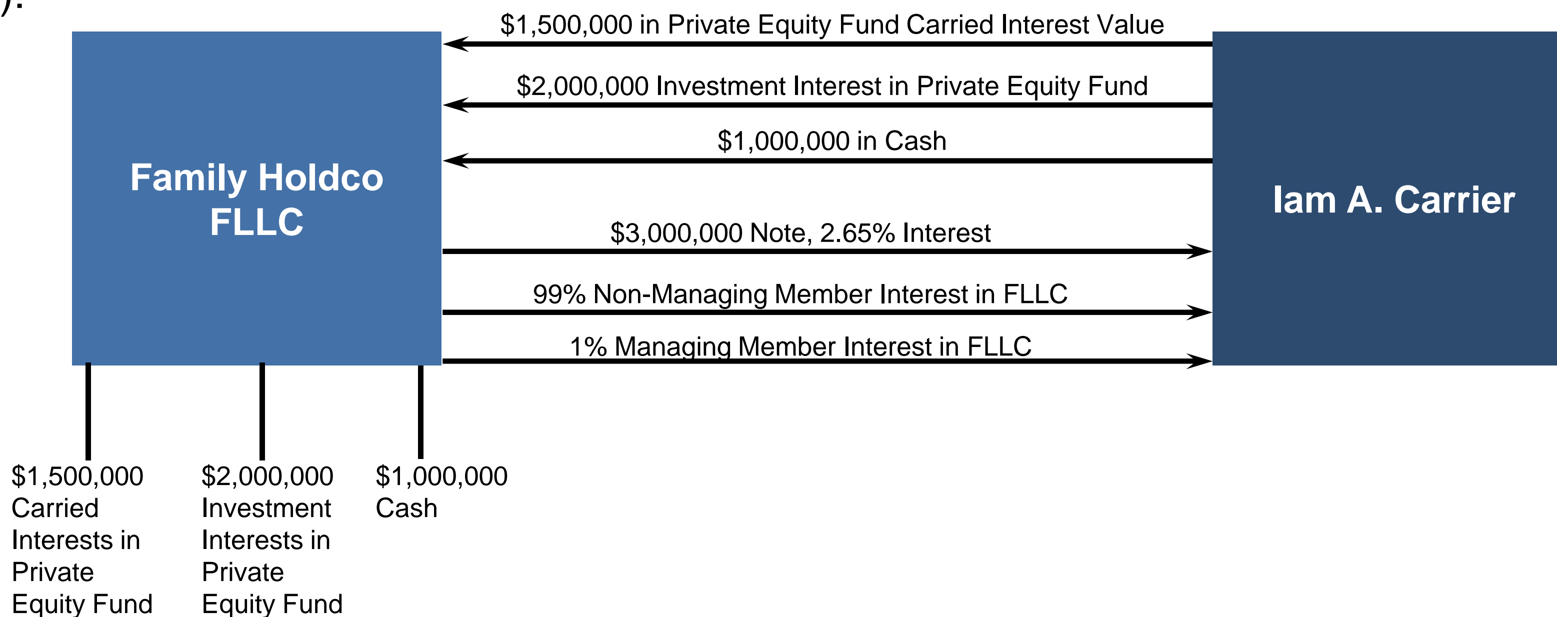
- Ms. Careful believes that if Mr. Carrier creates a FLLC to hold his interests, she would then be in a position to plan for Mr. Carrier's estate, without the investment interest "diluting" the planning opportunity for the carried interest. More specifically, Ms. Careful believes that if Mr. Carrier receives a note from the family holding entity that is equal to the value of the investment interest in the private equity fund contribution and contributed cash, there will be no dilution in her planning for the carried interest contribution to the family holding entity. The initial Holdco structure would be organized as follows (Scenario 1: Hypothetical Technique 20a):



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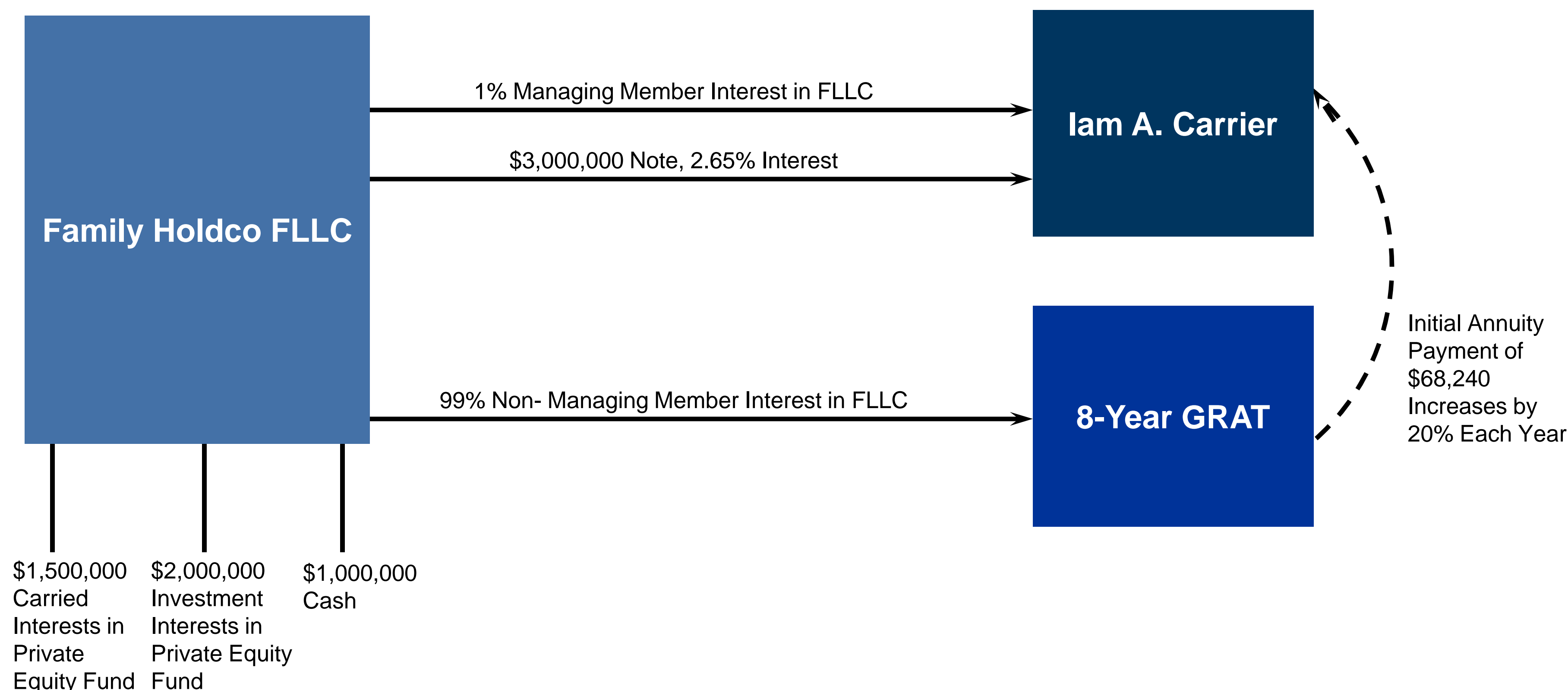
- Scenario 1: Hypothetical Technique 20b



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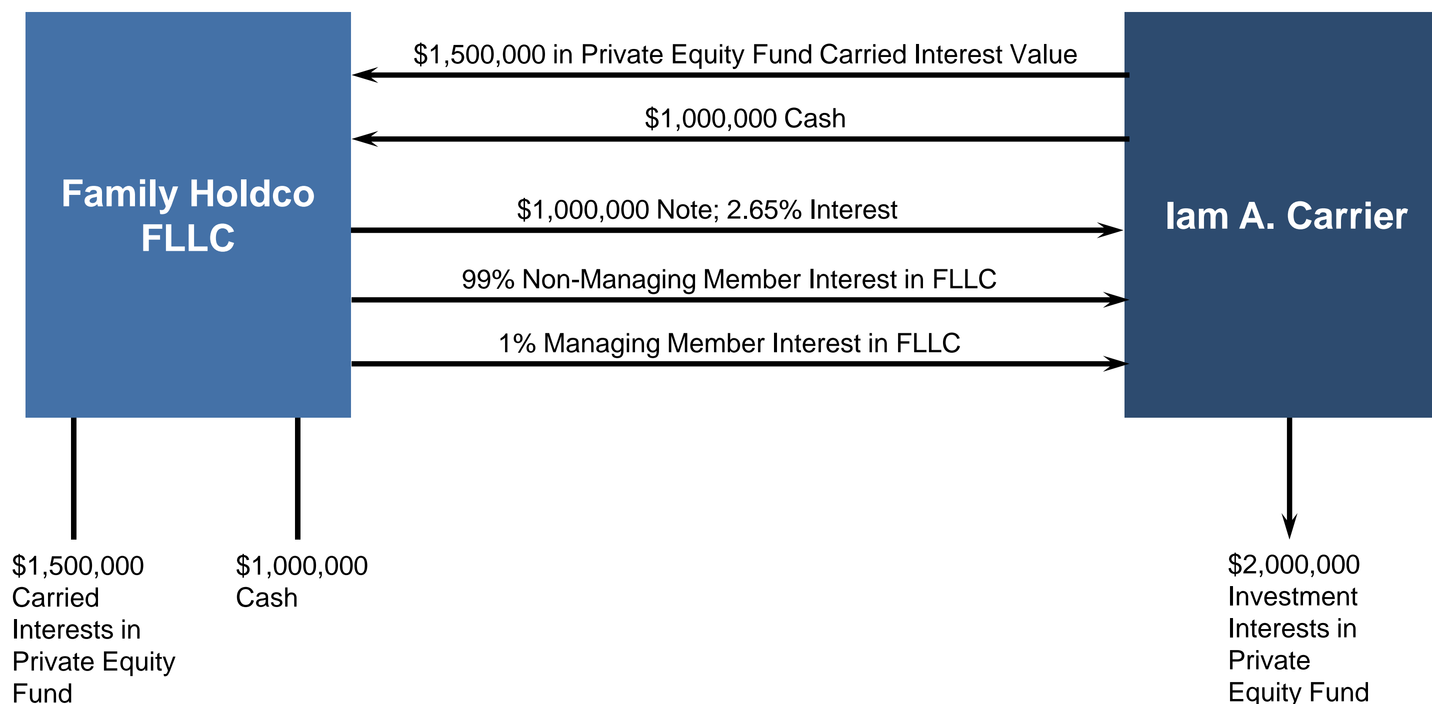
- An alternative structure, which may be subject to the valuation rules under IRC Sec. 2701, would be for Iam Carrier to contribute $1,000,000 along with the carried interest to Holdco. Iam A. Carrier would continue to individually own the investment interest in the private equity fund. The structure would be similar to the illustration below:
- Scenario 2: Hypothetical Technique 20c



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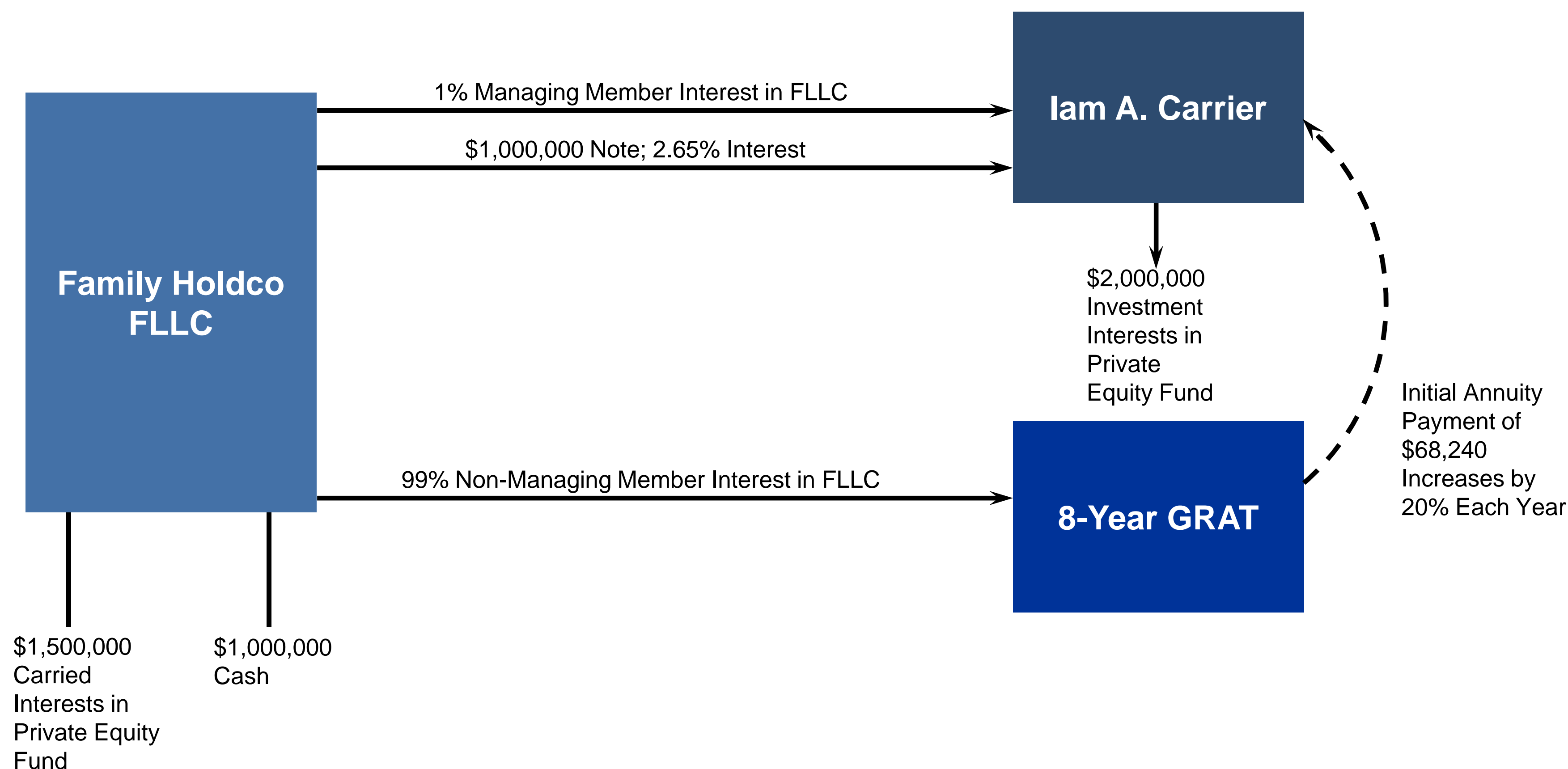
- Scenario 2: Hypothetical Technique 20d



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- Under the assumptions of this example, the estate planning results of scenario one and scenario two in comparison to each other and in comparison to no further planning are delineated below:

Technique	Carrier Family	IRS - Income Tax	IRS - Investment Opportunity Cost	IRS - Gift Tax (at 45%)	Total
No Further Planning; Transfers Estate to Family at the End of 8 Years	14,092,544	3,755,759	68,598	11,530,263	29,447,164
Planning Scenario #1: Iam A. Carrier Creates a FLP and Contributes $1,000,000 Cash, Carried Interest and a $2,000,000 Investment Interest in a Private Equity Fund that he Co-Manages; and the FLP Issues $3,000,000 in Notes to Iam A. Carrier with an Interest Rate Equal to the Federal Mid-Term Rate; Iam A. Carrier then Contributes FLP Interests to a GRAT; Iam A. Carrier Gives His Remaining Assets to His Family in 8 Years	24,886,627	3,769,157	68,598	722,783	29,447,164
*Planning Scenario #2: Iam A. Carrier Creates a FLP and Contributes $1,000,000 Cash and the Carried Interest; Iam A. Carrier Returns the Investment Interest in the Private Equity Fund; the FLP Issues $1,000,000 in Notes to Iam A. Carrier with an Interest Rate Equal to the Federal Mid-Term Rate; Iam A. Carrier Contributes FLP Interests to a GRAT; Iam A. Carrier Gives His Remaining Assets to His Family in 8 Years	24,447,268	3,497,229	68,598	1,434,069 *	29,447,164

* This scenario may also be subject to additional gift taxes because of the valuation rules under IRC Section 2701.

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- Observations:
  - Using two of the exceptions to the valuation rules of IRC Sec. 2701, (i) the proportionality exception (client contributes all of his interests (both his investment interest and his carried interest) in the private equity fund to the Holding FLP) and (ii) the debt exception (the investment interest is contributed in exchange for a note), in combination with a 20% annual increasing annuity GRAT, the results attained are similar to or enhanced over the results of contributing a partnership that solely owns a carried interest to a 20% annual increasing annuity GRAT, without the IRC Sec. 2701 valuation concerns.

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Private Wealth Management

Strategic Wealth Advisory Team - Biographies

Biographies

Stacy Eastland – Managing Director	Houston	Tel: (713) 654 – 8484

Stacy joined the firm to expand the advisory team working with Private Wealth Management clients. He currently works with private clients and their own advisors with their strategic wealth management plans, combining a variety of income tax, estate planning and gifting techniques. Prior to joining Goldman Sachs in October 2000, Stacy was a senior partner with Baker Botts, L.L.P. in Houston, Texas. Stacy received his B.S. (with Honors) from Washington and Lee and his J.D. from The University of Texas (with Honors). Stacy's professional associations include: Member of the International Academy of Estate and Trust Law; Fellow of the American College of Trust and Estate Counsel (Regent for 1992/1998 term); Member of the American Bar Association (Supervisory Council Member of the Real Property, Probate and Trust Law Section from 1990-1998); Member of the Texas Bar Association (Texas Bar Foundation Fellow); Member of the Houston Bar Association (Houston Bar Foundation Fellow). Stacy is listed in Who's Who in America and The Best Lawyers in America (Woodward/White). Stacy has also been listed in Town & Country and in Bloomberg Personal Finance as one of the top trust and estate lawyers in the U.S. Stacy was selected as one of the ten initial recipients of the Accredited Estate Planner® award of the Estate Planning Hall of Fame® (2004). Articles about Stacy’s estate planning ideas have also been featured in Forbes and Fortune magazines. Stacy is a prominent lecturer throughout the country.

Jeff Daly – Managing Director	Los Angeles	Tel: (310) 407 – 5828

Jeff joined Goldman Sachs in October 2000, after spending nine years with Arthur Andersen in Houston in the Private Client Services group as a Senior Tax Manager. Jeff's experience includes developing and implementing innovative strategies to assist his clients in meeting their income tax, estate tax, and financial planning goals. He has co-written or assisted with published articles addressing issues of estate planning, income tax planning, single stock risk management and stock option planning. He has been a past speaker at various tax conferences sponsored by state bar associations and law schools. He was recently named one of the "Top 100 Wealth Advisors" to ultra-high net worth individual clients in the United States by Citywealth magazine. He earned his B.S. in Economics with honors from the Wharton School of the University of Pennsylvania.

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Biographies

Clifford D. Schlesinger – Managing Director | **Philadelphia** | **Tel: (215) 656 – 7886**

Cliff is a member of the Goldman Sachs Strategic Wealth Advisory Team. He works with the firm's private clients and their own advisors to develop appropriate wealth management plans that often combine a variety of income tax, gifting and estate planning techniques. Prior to joining Goldman Sachs, Cliff was a partner with the law firm of Wolf Block Schorr and Solis-Cohen LLP. Cliff served on WolfBlock's Executive Committee and was Chairman of WolfBlock's Private Client Services Group. Cliff graduated, magna cum laude, with a B.S. in Economics from the Wharton School of the University of Pennsylvania. He received his J.D., cum laude, from the University of Pennsylvania Law School. Cliff was admitted to the practice of law in Pennsylvania and New York and he also received his C.P.A. license from New York. Cliff is a Fellow of the American College of Trust and Estate Counsel. He is a past President of the Philadelphia Estate Planning Council (PEPC). He was the PEPC's 1998 recipient of the Mordecai Gerson Meritorious Service Award. Cliff currently serves as the Treasurer and as a member of the Board of Trustees of the National Museum of American Jewish History. Cliff also serves on the Board of Overseers for the Albert Einstein Healthcare Network. Cliff previously served as President of the Endowment Corporation and on the Board of Trustees of the Jewish Federation of Greater Philadelphia. Cliff was the 2008 recipient of the Edward N. Polisher Award in recognition of his distinguished service to the Philadelphia Jewish Community. Cliff was also the 2003 recipient of the Myer and Rosaline Feinstein Young Leadership Award presented for exceptional service to the Philadelphia Jewish Community. Cliff has been a frequent author and lecturer on estate planning and transfer tax related topics including estate planning for corporate executives and estate/gift tax issues relating to "Family Limited Partnerships."

Karey Dubiel Dye – Managing Director | **Houston** | **Tel: (713) 654 – 8486**

Karey joined Goldman Sachs in October 2000, after practicing law for 14 years at the law firm of Vinson & Elkins L.L.P. in Houston, Texas. While in private practice, Karey specialized in trusts and estates and tax exempt organization matters. Currently, Karey works with private clients and their own advisors on estate planning and family wealth transfer matters as well as with institutional clients served by Goldman Sachs Private Wealth Management (foundations, endowments, and other charitable organizations). Karey also assists donors and their advisors in developing efficient charitable giving strategies, including the creation and administration of non-profit family charitable vehicles such as private foundations, donor advised funds, and supporting organizations. Karey also serves as the President of the Goldman Sachs Philanthropy Fund, a donor advised fund which is a public charity established to encourage and promote philanthropy and charitable giving across the United States by receiving charitable contributions, by providing support and assistance to encourage charitable giving, and by making grants to other public charities and governmental units. Karey graduated from Middlebury College, B.A., cum laude, and the University of Virginia School of Law, J.D. She was admitted to the practice of law in Texas. In Houston, she serves on the board of DePelchin Children's Center, on the endowment board at St. Martin's Episcopal Church where she serves as its President, and on the board of Episcopal High School.

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Strategic Wealth Advisory Team (continued)

Private
Wealth
Management

Biographies

Melinda M. Kleehamer – Managing Director | **Chicago** | **Tel: (312) 655 – 5363**

Melinda M. Kleehamer has worked exclusively with ultra-high net worth families for over twenty-five years. As a member of SWAT, Melinda helps PWM clients and their advisors with sophisticated income, gift and estate planning techniques. Melinda spent the first fifteen years of her career practicing gift and estate planning law with national and international law firms, most recently as a capital partner in McDermott Will & Emery's Private Client Department. At McDermott, Melinda focused on pre-transaction planning, family business issues, family wealth education, complex gift planning and valuation methodologies. After leaving the practice of law, Melinda maintained a private client practice focused on communication, decision-making and conflict resolution workshops specifically tailored to her clients' individual, family and philanthropic goals. She also led a sales and advisory team at Bank of America that managed investment, trust, deposit and credit services for her clients. Melinda is a summa cum laude graduate of the State University of New York at Brockport, an honors graduate of the University of Chicago Law School and a member of the Order of the Coif. She is a member of the Distribution Committee of a family foundation and deeply involved in charitable activities intended to alleviate suffering of all kinds.

Adam Clark – Managing Director | **New York** | **Tel: (212) 357 – 5177**

Adam Clark is a member of the Strategic Wealth Advisory Team, where he provides tax and wealth planning education focused on gift and estate tax planning, income tax planning and philanthropic planning. Adam also has extensive experience in the international tax area, having advised high net worth clients with multi-jurisdictional tax and financial interests, including non-U.S. investments and families of multiple citizenship and residence. He has also helped many families to satisfy their U.S. tax reporting obligations with respect to interests in non-US structures, such as offshore trusts and foreign investment vehicles. Prior to joining as a member of the Strategic Wealth Advisory Team in the Goldman Sachs' New York office, Adam was a managing director at WTAS FLLC, where he led the international private client group, helping domestic and international families with their tax, financial planning and business interests. Adam holds an LL.B in English law and German law from the University of Liverpool and achieved the BGB (German civil law) from the University of Würzburg.

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Strategic Wealth Advisory Team (continued)

Biographies

Michael L. Duffy – Vice President | **Atlanta** | **Tel: (404) 846 – 7224**

Michael L. Duffy serves two roles at Goldman Sachs: (i) Southeast Trust Strategist for the Goldman Sachs Trust Companies and (ii) Southeast representative of the Strategic Wealth Advisory Team (SWAT). Prior to joining Goldman Sachs in May 2007, Michael was a Senior Director of New Business Development with Mellon Financial. Before joining Mellon, Michael served as a Vice President and Wealth Advisor in the JPMorgan Private Bank, where he provided counseling and planning services to ultra-high net worth families. Preceding his tenure at JPMorgan Private Bank, Michael practiced law in Palm Beach, Florida with Alley, Maass, Rogers & Lindsay, P.A. where he was central to the firm's income tax, transfer tax and sales tax practices. Michael started his career after law school as an in-house research associate for Coopers & Lybrand. Michael was awarded his B.A. from Flagler College, his J.D. from Ohio Northern University and his LL.M. in Taxation from the Georgetown University Law Center. Although he does not currently practice law, he is a member of the American Bar Association and the Florida, North Carolina, South Carolina and Atlanta Bar Associations. Michael is currently serving a two-year term as Treasurer on the Board of the Atlanta Estate Planning Council.

Cathy Bell – Vice President | **Houston** | **Tel: (713) 654 – 8462**

Cathy joined the Strategic Wealth Advisory Team (SWAT) in May 2009, after spending 17 years with Stewart Title in Houston, Texas working in their property information technology division. Cathy received her B.B.A. in Finance from the University of Texas and her M.B.A. from the University of Houston. Cathy is a current board member of a local chapter of the National Charity League.

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