CREATIVE ESTATE PLANNING STRATEGIES

Some Selected Recipes

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OVERVIEW

- Goals of Estate Planning
- The "Ultimate" Estate Plan
- Trusts
- Exploiting Valuation Uncertainties
- It Pays to Give — Difference Between the Estate Tax and Gift Tax Systems
- Disgorging Existing Wealth
- Opportunity Shifting

INTRODUCTION

Most estate planners recognize that there are two tax systems, one for the informed and another for the uninformed. The same rule is also applicable for those who use creditor protection strategies as compared to those who do not. The tax and asset protection (including divorce) benefits which can be derived through a well-conceived family wealth planning structure as compared to an unplanned arrangement are substantial.

Transfer Tax Savings Opportunities. Since federal unified transfer tax brackets start at 37% for the first dollar taxed and reach 55% (and 60% if the surcharge is applicable) and the generation skipping transfer tax is imposed at the highest estate tax bracket (currently 55%) for each generation skipped for all non-exempt transfers, the stakes are high. The ability to significantly erode the imposition of these somewhat punitive taxes by engaging in sophisticated estate planning maneuvers has been expressed as follows:

> "The fact that any substantial amount of tax is now being collected can be attributed only to taxpayer indifference to avoidance opportunities or a lack of aggressiveness on the part of estate planners in exploiting the loopholes that exist....For those who do not want to contribute their estates to the government (or to charity), there is an impressive array of strategies for moving wealth from one generation to another outside the purview of estate and gift taxation." Cooper, "A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance," 77 Col. L. Rev. 161, 164 (March 1977).
>
> "In fact, we haven't got an estate tax, what we have, you pay an estate tax if you want to; if you don't want to, you don't have to." Statement of Prof. A. James Casner, Hearing before the House Ways and Means Comm., 94th Cong., 2d Sess., pt. 2, 1335 (1976).

Asset Protection. Because of the general litigious nature of our society coupled with the increasing success plaintiffs are enjoying and the proliferation of divorces, creditor protection should be an integral portion of the planning process. It would be a reasonable observation that although there is a general dislike of paying taxes, paying to the federal fisc would be generally more palatable for most than paying a judgment creditor or a divorce settlement.

GOALS OF MODERN ESTATE PLANNING

- **Control — Management**

- **Tax Savings — Income, Gift, Estate and Generation-Skipping Transfer Tax**

- **Valuation Manipulation — Exploiting:**
  - **Valuation Uncertainties**
  - **Valuation Concepts**

- **Asset Protection Planning**
  - **Lawsuits — Future Creditors**
  - **Divorces**
  - **Litigious Society**
  - **Sinister Connotation**
  - **Myriad of Options**
  - **Trusts "Use" Concept**

- **Flexibility**

- **Providing for Liquidity at Death**

Goals of Modern Estate Planning[1]

Preserving Control. Typically, for family planning and psychological purposes, it is essential that control be retained by the senior family members during their lifetimes. Upon the death of the senior family members, most clients wish to shift control into the hands of the members of the oldest surviving generation and, all other things being equal, enable the oldest surviving generation to be the favored class with respect to enjoying the use and benefits of the transferred property (i.e., children are generally favored over grandchildren).

Control held in a fiduciary capacity will not be disturbed by either the fiduciary's personal creditors or the beneficiary's creditors.

The goal of preserving control in the hands of senior family members while shifting the tax consequences from those individuals is usually easily obtainable.

For example, managerial control can be given by trusteeship arrangements or by making the desired individual (including the transferor), or an entity which he or she controls, a general partner in a limited partnership.

Control over the disposition of the property may be given to a person through a broad special power of appointment in a trust document, typically without adverse tax consequences. The power holder need not even be a beneficiary.

Moreover, neither the fiduciary's creditors nor the creditors of power holders can disturb these principles.

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[1]The following quotation, from what I consider to be the classic treatise on the exploitation of the transfer tax system, summarizes the goals of sophisticated gift giving, as follows:

> "It has always been worthwhile, and is now virtually essential, for the superior estate planner to recommend more than simple, straightforward gift-giving. Where the estate planner has traditionally earned his fee is in accomplishing one or more of three sophisticated goals in gift-giving -- preserving continuing control of and benefits from the transferred property in the hands of the client, reducing or avoiding the need to pay immediate gift tax on the transfer, and passing on more value than meets the taxable eye in the transfer." Cooper, "A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance," 77 Col. L. Rev. 161, 171 (March 1977). The goals of modern estate planning are somewhat broader.

Tax Savings. Reducing, avoiding and deferring the imposition of tax, primarily income taxes, gift taxes, estate taxes and the generation skipping transfer tax ("GSTT"), is an integral part of family wealth planning. One of the key weapons in an estate planner's arsenal is to accomplish these goals by taking advantage of valuation strategies and leveraging opportunities.

Since 1976 we have been taxed under a unified estate and gift tax structure whereby gifts and transfers at death are aggregated and transfers taking place at death are treated as the last gift.

The punitive GSTT is imposed in addition to the estate and gift taxes on the same transaction. The rate is the highest estate and gift tax bracket, currently 55% (after the exemption of $1,000,000) for each generation skipped.

Value Manipulation. "Passing on More Value Than Meets the Taxable Eye.[2] The ability to manipulate value to achieve tax savings within the family unit presents unique opportunities for the tax practitioner.

Asset Protection Planning. Although it has always been a worthwhile consideration, asset protection and liability planning is becoming a more integral part of the business and estate planning processes. Traditional tax planning arrangements with appropriate modifications work well in this new planning environment and are not only compatible with asset protection techniques, but each enhances and solidifies the benefits of the other.

Flexibility. Flexibility to meet changing family needs and changing laws, particularly tax laws, has increased in scope, especially due to the increased focus on multigenerational tax and family planning.

Providing for Liquidity at Death. Many years ago Ben Franklin made the observation that there are two certainties in life - death and taxes.[3] For most wealthy persons it is death which causes the largest tax bill, and in a properly planned estate, provisions must be made to deal with that eventuality.

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[2]See Cooper at fn 1, p. 3.

[3]It has been stated that the major difference between death and taxes is that death doesn't get worse each time Congress meets. It also appears that there now are three certainties — death, taxes and tax reform.

Just like the fact that none of us relishes the idea of growing old, we all realize that it sure beats the alternative. None of us enjoys buying life insurance, but in most instances it also is far superior to the alternative. (e.g., illiquid estate, beneficiaries who need economic assistance, etc.)

Traditionally, life insurance has been acquired for (i) estate creation and (ii) estate preservation. However, with new products and planning techniques, life insurance may also be arranged to provide lifetime benefits, such as tax deferred growth.

THE ULTIMATE ESTATE PLAN

- **Most of Us, If We Are Completely Candid, Want an Estate Plan Whereby We:**

  - **Have Access to the Income From Our Property Until Death**
  - **Have Our Assets Available for Our Use**
  - **Can Decide Later Who Will Receive the Property at Our Death (or Earlier if We Decide to Give It Away) and How They Will Receive It**
  - **Can Manage and Control Our Property Until Death**
  - **Can Have Our Property Protected from Creditors, Including Spouses in the Context of Divorce**
  - **Can Save Taxes**

THE ULTIMATE ESTATE PLAN

The Philosophy. Receiving property in a trust which is controlled by the primary beneficiary is a far more valuable commodity than receiving property outright for both tax and creditor protection purposes. This concept has been expressed as follows:

> "In planning for any major gift or inheritance that is to go to a fully mature, competent family member, the donor/testator has an opportunity to *enhance* the gift or inheritance by providing the beneficiary with a trust to shelter that property from future taxes and creditor claims — something the beneficiary cannot do for himself. In my view, this shelter goal is the most prevalent reason for having a trust.
>
> In modern times, a trust created by someone other than the beneficiary can be a vital *shelter* (i) from at least some of the beneficiary's taxes, (ii) from the beneficiary's creditors, and (iii) from the beneficiary's potentially dissident spouse seeking alimony, property, or an undue share on the beneficiary's death.
>
> In terms of the trustee arrangement for such a shelter trust — for a fully mature, competent family member — why should not the beneficiary be given as much control over the gift or inheritance fund as a beneficiary can be given and still achieve the 'shelter' benefits for which the trust is being created?" Keydel, "Trustee Selection, Succession and Removal: Way to Blend Expertise With Family Control," 23 U. Miami on Estate Planning, Ch. 4 at ¶4033 (1989).
>
> * * *
>
> Such a "trust might best be described as an 'if it weren't for taxes, I'd leave it all outright' trust. But, it is *more* than a tax shelter! It is also a protection against creditors (including the beneficiary's spouse as a potential claimant). Thus, from the beneficiary's point of view, the beneficiary is:
>
> 1. Better off receiving any gift or inheritance *in trust*, rather than outright,

> 2. *Provided* the beneficiary is truly *in control* of the trust.
>
> Thus, where the trust's creator has *no* wish to protect the beneficiary against himself — he is a fully mature, competent family member (whether spouse, child, or grandchild of the donor/testator), it is not only appropriate but *essential* to give that primary beneficiary maximum control over his trust and trustees, limited only to the extent necessary to achieve those shelter goals." Keydel, supra.

The "Pipe Dream" Trust. Many years ago the fertile mind of Los Angeles attorney John R. Cohan coined the concept of the "Pipe Dream Trust." John stated, "Naive clients, if they are completely candid, will say that they want a gift that helps their children and saves taxes. However, they also want a chance to use the property themselves in case of adversity, desire management power over the trust estate, and wish to decide later when the children will receive the property." Drafting California Irrevocable Trusts, John R. Cohan, ed., ¶8.11.

Indeed, such a trust would be a "pipe dream" for anybody who makes a gift to the trust. For any non-grantor beneficiary of this structure, a beneficiary controlled trust is the ultimate estate plan. A properly structured beneficiary controlled trust set up by anyone other than the beneficiary can give the beneficiary all of the rights, benefits and enjoyment of outright ownership plus save taxes and shelter the trust assets from creditors and divorce awards.

The Creditor Protection. A discretionary trust with an independent trustee has been described as "...the ultimate in creditor and divorce claims protection — even in a state that restricts so called 'spendthrift trusts' — since the beneficiary himself has no enforceable rights against the trust." Keydel, supra at ¶409.1. In other words, if you don't own it, nobody can take it from you. The creator of the trust sets the rules as to who may benefit from the trust.

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Asset Protection Planning: A Critical Part of Any Estate Plan

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Anne Fasbee was a senior tax partner in the Los Angeles office of a national accounting firm. She was a proud professional who was thorough and ethical in her work. She was also extremely hard working and successful. By the time she was in her early forties, she was earning a hefty salary and had managed to accumulate a sizable net worth.

Anne was as diligent with her personal affairs as she was with her clients' affairs. Her and her spouse's estates were as planned as they could be (or at least so they thought), with pour-over wills, revocable living trusts, durable springing powers of attorney, living wills, a recently funded irrevocable insurance trust, a trust for each of their three children, burial instructions, and a charitable remainder unitrust. The Fasbee financial plan was also finely tuned, with net after tax returns for the previous several years averaging well into the upper reaches of ten something. Unfortunately, as well-planned as the Fasbees were, one very important form of planning soon became quite conspicuous by its absence.

The first of a series of lawsuits was served upon Anne's accounting firm in September of 1987, shortly after the Fasbee family returned from three weeks in Spain and Italy. This suit was a class-action suit alleging, among other things, that fraudulent and misleading financial statements were prepared by the firm's Houston office in connection with a public offering of subordinated debentures. The next two suits involved allegedly faulty tax opinion letters rendered by the firm through its offices in Denver and Chicago. Several other suits followed as well. After failing to have two adverse judgments reversed on appeal and following the tremendous drains on the firm's cash and other resources due to the strains and expenses of "fighting the battles," the partners voted to seek federal bankruptcy protection for the firm. As a consequence, many of the firm's partners had no choice but to do the same. This included Anne, and as a consequence her spouse as well, due to the Fasbees residing in a community property state wherein community assets were available to satisfy the separate debts of either spouse.

At last report, Anne was a single parent and solo practitioner sharing office space with a number of other professionals. By this most unfortunate personal experience, Anne learned that all of her sophisticated estate and financial planning was of little value to an estate that was itself of little value. Had the Fasbees included appropriate asset protection planning as part of their overall planning, the ultimate outcome of their misfortunes would more than likely have been much more favorable. It certainly would not have been any worse.

Definition of Asset Protection Planning

Asset protection planning may be simply described as the process of organizing one's assets and affairs in advance so as to guard them from loss by reason of some future fiscal calamity. The phrase "in advance" warrants strong emphasis, for one (including the planner) must be cautious and avoid the negative implications which may follow from planning to protect assets other than in advance, that is, when there are creditors who are entitled to remedies under applicable fraudulent conveyance and similar laws.

Asset protection planning concepts may be applied to protect every type of asset, whether cash, stocks, bonds, business interests, insurance proceeds, jewelry, art, antiques, real property, and so on. While asset protection planning is typically applied in the context of protecting individually accumulated wealth, a number of applications exist for the operating business or professional practice.

Why Asset Protection Planning

The idea of guarding in advance against the potential of a future legal liability is not a new one. Indeed, today an attorney who fails to advise a client to incorporate a business to protect the business owner against the personal risks of owning and operating a business would no doubt wish his or her own asset protection planning was in place. A number of factors have evolved through the course of the 1980's, however, that make persons with wealth not only more aware of the need to engage in some form of protective planning, but which in fact leave those who fail to plan more exposed than ever before. These factors are as follow:

1. **Expanding Theories of Liability**—By definition, a system whose legal decisions are based on legal

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Mr. Engel received his bachelor of science degree in business (with an accounting emphasis, *magna cum laude*) from the University of Colorado at Boulder in 1976 and his law degree (with honors) in 1979 from the University of California, Hastings College of the Law. He is a Fellow and Senator of the Isle of Man based Offshore Institute.

precedent will be subject to expansion of its theories of liability, for each decision in the chain will set the stage for the next step of expansion. This, coupled with the increasing willingness of judges and juries to expand a theory of liability, leave a tremendous amount of uncertainty and exposure for the person who has relied on traditional forms of planning.

For example, a recent Colorado case held that an accounting firm was liable to pay an employee's surviving spouse the employee's salary for the rest of the surviving spouse's lifetime, when the employee was attacked and killed as she left work one evening. The court stated that "[t]his death arose out of and was in the course of her employment," as if being brutalized was part of her duties, and totally ignoring the fact that the person who committed the crime was entirely to blame. Is the next step for a court to hold a company liable if the employee chokes on a sandwich in the lunchroom?

Ten years ago, the idea that a smoker who developed lung disease would sue a tobacco company seemed ludicrous, while today we have become familiar with this theory of legal liability. Is it possible that in 10 years we will become familiar with carnivores with heart disease suing the corner store where they had over the years purchased their red meat?

2. Result-Oriented Judges and Juries—A recent survey conducted by the American Bar Association concludes that the personal opinions of judges often enter into the decisions rendered, to the (at least) partial exclusion of what the law provides the result should be. Furthermore, a "someone must pay" attitude seems prevalent in our society today.

Political reasons are another factor. To quote a justice of a state's highest court from his recent book: "As long as I am allowed to redistribute wealth from out-of-state companies to injured in-state plaintiffs, I shall continue to do so. Not only is my sleep enhanced when I give someone else's money away, but so is my job security, because in-state plaintiffs, their families and their friends will reelect me."

3. Outrageous Jury Awards—Consider the case of a man who was hit by a subway train and lost an arm after he fell drunk onto the tracks. A jury awarded him $9.3 million. The plaintiff, a Mexico citizen who had been in the United States for six months working as a dishwasher before the accident occurred, responded by exclaiming "God bless America."

Another example involves a $55.7 million jury award against Woodmen of the World Life Insurance Company whose representative "improperly persuaded" the plaintiff to invest her life's savings in insurance products.

4. Concerns with Traditional Forms of Protection—The corporate veil is seemingly more piercable than ever before. Concerns with insurance coverage exist as well, whether it is with the solvency of the carrier, its continued willingness to write coverage, the existence of policy exclusions (e.g., punitive damages or damages which result from acts of gross negligence) or the like.

5. Jury of One's Peers—Those of means who have ever considered the question generally feel that there would probably never be such a thing as a jury of their peers. Few litigators could claim to have ever tried a case before a jury comprised of individuals the average net worth of whom even approached that of the wealthy defendant.

6. Deep-Pocket Syndrome—An ongoing advertising campaign by an asset search firm shows two lawyers huddled over a table with one of the lawyers commenting to the other that "the defendant has assets, so let's proceed." The converse to this would be that "the defendant doesn't have much, so let's not bother."

The golden rule used to be that "he with the gold, rules." The new golden rule may well be "he with the gold, pays."

Many good arguments may be advanced on behalf of the contingency fee system. At least as many good arguments may be advanced against such a system, including the manner in which it fuels litigation and otherwise often results in groundless or frivolous suits being brought by a plaintiff's counsel whose hope is to roll the settlement dice with the client rather than to proceed to a trial on the merits.

7. Once You've Been Sued You've Lost—Imagine a scenario wherein a defendant is found not liable five years and hundreds of thousands of dollars in legal fees after the initial complaint was filed. In the interim, the defendant has had many sleepless nights and has suffered tremendously both in terms of anxiety and inconvenience. The business and marriage have also suffered from absences and distractions. But ... he won!?! Perhaps it would have been preferable to have either discouraged the suit in the first place, or to have been in a position to encourage an early and cheap settlement.

In his book, *The Litigation Explosion*, Walter Olson argues that "[a] litigator can come around, dump a pile of papers on your front lawn and you can go literally broke trying to respond to it." Speaking of which . . .

8. The Litigation Explosion—It is unfortunate that efforts at tort reform have done little to curb the ever increasing spiral of lawsuits. It was reported by *The Wall Street Journal* on May 7, 1991, that "[n]early 100 million new cases were added to the dockets of the nation's state court system in 1989, with new filings of civil damage suits up sharply from the year before." This number does not include the numerous new cases that were added to the federal dockets that same year.

Goals of Asset Protection Planning

Having defined asset protection planning, and having analyzed the reasons why this form of planning is increasingly becoming of interest to persons of means, the goals

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YOUR RIGHTS IN A TRUST WITHOUT EXPOSING THE ASSETS TO ESTATE TAX

- Income for Life
- Principal — for Health, Education, Support and Maintenance
- "5 or 5" Power
- "Use" Concept — Trust Assets May Be Used by Trust Beneficiaries for Any Purpose
- Special Power of Appointment — Right to Give Property to Others
  - Ability to Rewrite the Trust
  - Ed Halbach — "A Power of Appointment Is Also..."
- Trustee — Management
- Independent Trustee — Can Confer Additional Benefits and/or Increase Tax Benefits and Creditor Protection

TWEAKING THE TRUST

- **Income Taxation of Trusts**
  - **General Rule**
  - **Defective Trusts — IDIT**
- **Avoid Mandated Distributions**
- **"Use" Concept**
- **Require That Beneficiaries Be Productive Members of Society**
- **Revocable/Irrevocable Trust Concept**
- **Security of the Trust Enables Beneficiaries to Defund Their Estates**
- **Multiple Trustee Arrangements**
- **Trustee Removal and Replacement Rights (Rev. Rul. 95-58)**

ECONOMICS

- **ASSUMPTIONS: $1 Million; Trust Lasts 120 Years And Earns 8%; 55% Transfer Tax Every 30 Years**

  - **No Trust — $420,436,792**

  - **Dynastic Trust — $10,252,992,943**

Annual After-Tax Growth	Value of Megatrust After 120 Years	Value of Property If No Trust
6.00%	$ 1,088,187,748	$ 44,622,499
7.00%	$ 3,357,788,383	$ 137,690,310
8.00%	$ 10,252,992,943	$ 420,436,792
9.00%	$ 30,987,015,749	$ 1,270,661,315
10.00%	$ 92,709,068,818	$ 3,801,651,253
11.00%	$ 274,635,993,245	$ 11,261,792,198
12.00%	$ 805,680,255,013	$ 33,037,925,957

CONCEPT OF

"FAIR MARKET VALUE"

- **Gift Tax Regs. — Estate Tax Regs.**

- **"Willing Buyer — Willing Seller" Definition**

  - **Willing Buyer**
  - **Willing Seller**
  - **Neither Being Under Any Compulsion to Buy or Sell**
  - **Reasonable Knowledge of the Relevant Facts**
  - **Hypothetical Transaction**

- **Trusts and Estates (Dec., 1990) — Average Discount = 71.45%**

CONCEPT OF "FAIR MARKET VALUE" — "WILLING BUYER — WILLING SELLER" CONCEPT

Estate tax regulations.

"The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." (Emphasis supplied) Treas. Reg. §20.2031-1(b).

Gift Tax Regulations.

> "Section 2512 provides that if a gift is made in property, its value at the date of the gift shall be considered the amount of the gift. The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." (Emphasis supplied) Treas. Reg. §25.2512-1.

OPPORTUNITIES AVAILABLE TO EXPLOIT VALUATION UNCERTAINTIES

> "**Value is what you make it**, while appearing initially to be an overstatement, often is an accurate description of the effective use of planning to minimize tax consequences of intra-family transactions, including gifts, installment sales, multiple business or investment entities, and the shifting of asset-building opportunities." (Emphasis supplied) Fiore, "Ownership Shifting to Realize Family Goals, Including Tax Savings," 37 N.Y.U. Inst. on Fed. Tax, Sec. 38 (1979).

> "**Valuation Discounts (The Strange Case of Disappearing Value)**. All non-cash gifts or transfers at death subject to estate and gift taxation must of course be valued, and an extraordinarily productive technique for reducing taxes on these transfers is to exploit valuation uncertainties. Aggressive tax lawyers have developed a package of valuation stratagems which cuts deeply into the estate and gift tax base. They have succeeded to a shocking extent in winning judicial approval of these techniques and Internal Revenue Service acquiescence in them. As a consequence, it appears possible, with a bit of advance planning, to have transfer taxes apply to as little as one-third of the real value of property transferred by gift or bequest. The remaining value simply disappears for transfer tax purposes thanks to valuation discounts." Cooper, "A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance," 77 Col. L. Rev. 161, 195 (March 1977).

"**An Estate Planner's Dream.**" The ability to manipulate value even within the family unit in order to obtain valuation discounts presents a unique opportunity for the tax planner. This situation has been called an "estate planner's dream."

> "...Worst of all, the courts and even the expert appraisers representing the government allow for these factors in cases where the allowance makes absolutely no sense from the viewpoint of intelligent estate and gift tax enforcement. For example, blockage may be a genuine problem for someone who is actually forced to unload a major block of stock in a distress sale, but what relevance does it have to someone who has no such need? The lack of voting control suffered by a minority interest may be a substantial problem for a stranger to a family corporation, but it hardly has the same meaning to the partial owner of a corporation whose spouse owns

enough additional stock to provide control. Problems of marketability, costs of flotation and restrictions on disposition may bother someone who plans to sell stock, but for the owner of a chunk of a family business which he intends to keep, these matters may be beside the point. Indeed, in many cases, so-called valuation discount factors may actually enhance the value of stock to the owner, as in the case of a restriction on disposition which is part of reciprocal restrictions on other shareholders. Yet, in case after case, the courts apply these factors, seemingly oblivious to the special family circumstances in which the valuation is being made. The ultimate result is an estate planner's dream..." Cooper, "A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance," 77 Col. L. Rev. 161, 197 (March 1977) (Emphasis supplied).

Discount Range 40% - 85%. "Most family businesses (including a family's financial assets) will be valued lower than at their liquidation value, if the owner's only likely way of receiving a return on his investment is through that business' cash distributions. This is because in a family business the family generally invests most of the earnings back into the business, rather than distributing them to the owners. If the bulk of the earnings of a business are utilized internally, then a purchaser of an owner's interest in that business, who does not acquire liquidation control, will pay a lower price than would be the case if there existed a higher distributable yield. On the other hand, if a prospective purchaser of a business interest can acquire liquidation control, then he will pay a higher amount, because he is then put in a position to acquire those internalized earnings. Tax case law has established that the difference between liquidation value and the capitalized distributable cash flow value may be substantial. Generally, courts in the last decade have found that the differences in these values, depending upon the distributable cash of the business, have a range between 40% to 85%. Stated differently, if a client does not have liquidation control of a family business, his or her interest in the enterprise may have a value which is 40% to 85% lower than could be the case if the client does have liquidation control." S. Stacy Eastland, "The Art of Making Uncle Sam Your Assignee Instead of Your Senior Partner: Using Partnerships in Lieu of Life Insurance Trusts to Hold Insurance and Other Heresies."

Discounted Cash Flow Concept. "An FLP should be formed as a term-of-years partnership under the Act. If an FLP is a

term-of-years partnership, a limited partner may not withdraw before the end of the term. A general partner of a term-of-years partnership has the power to withdraw at any time prior to the end of the term, but a withdrawal by the general partner will breach the partnership agreement. A general partner who breaches the partnership agreement is liable for damages,... A term-of-years partnership specifically provides that the FLP is to continue to the end of its term; thus, the remaining general partners may continue the FLP. If there are no remaining general partners, the FLP can be reconstituted and continued if all remaining partners agree in writing and they appoint new general partner(s). Thus, if there are multiple general partners and all partners agree, the FLP can be reconstituted and continued upon the event of dissolution.

If a donor is willing to give up liquidation control of his business unilaterally and instead would share it with his family (the donor and the family members together share the liquidation control rights), the liquidation value of the business is almost irrelevant. The relevant question becomes, what is the distributable cash flow of the business? ...Once it has become apparent that the distributable cash flow of the FLP will be a determining factor in establishing the valuation of a partnership interest, an appraiser will use the capitalization method for establishing fair market value. The value of the partnership interest will be valued in the hands of the donee rather than in the hands of the donor." Thomas C. Baird, "A Drafting Guide to the Family Limited Partnership."

Discounts for Stocks Of Closely Held Corporations

Do non-marketability and minority position discounts remain applicable to the same degree?

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In the December 1984 issue of TRUSTS & ESTATES, we reviewed the studies on non-marketability and ninority position discounts. We found hat these discounts averaged 39.86 perent for non-marketability and 29.37 ercent for minority position. This coninued to support the general belief mong investors, the courts, the Interal Revenue Service and others that priately or closely held securities are typcally valued at a discount from their ublicly held counterparts. There is also eneral recognition that many minority ositions require a discount because of heir inherent disadvantages versus a ontrol position.

We updated our review to see if the ercentages had changed. We want to now if the non-marketability and miority position discounts remain appliable to the same degree.

lon-Marketability Studies

Table 1 reveals that the non-marketbility discount for closely held common stock still has a wide range. The average remains about the same as in the earlier review, 42.02 percent.

Minority Position

The discount for a minority position also remains. It has long been recognized that the sum of minority positions is not necessarily equal to the value of the whole. Like the non-marketability discount, the minority position discount is unique and varies from situation to situation. Minority discounts range from 15 percent to 78 percent. The 29.63 percent average is virtually unchanged from the 29.37 percent average previously observed.

We want to know if the non-marketability and minority position discounts remain applicable to the same degree.

Conclusion

A growing body of studies continues to support minority position and nonmarketability discounts. Of course, these results are not recognized to the same degree in all situations and by all typically involved. □

FOOTNOTES

The articles and studies referred to in this paper include:

Arneson, George S., "Minority Discounts Beyond 50 Percent Can Be Supported," *Taxes-The Tax Magazine*, February, 1981, pp. 97-102.

Bettner, Jill, "Getting Out of a Limited Partnership Can Mean Getting Little Back," *Wall Street Journal*, November 29, 1988.

Cannon, R.B., "Share and Share—but Not Alike," *London Financial Times*, August 17, 1985.

Cohen, Zinbarg, and Zeikel, *Investment Analy-*

Reprinted from Trusts & Estates, December 1990

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TABLE 1

Discounts for Non-Marketability and Minority Position

Study	(Non-Marketability) Range	(Non-Marketability) Average	(Minority Position) Range	(Minority Position) Average	(Minority Position) Suggested
Arneson	—	—	15-55%	34.0%	> 55%
Bettner	—	53.9	—	—	—
Cannon	—	—	—	—	—
Cohen/Zinbarg/Zeikel	A mere piece of paper without dividends or liquidation				
Coolidge	—	—	> 20-78	36.1	—
Dant	—	—	15-55	34.0	42
The CPA Journal	—	—	—	—	—
Emory	4-87	60.0	—	—	—
Feld	—	—	—	—	—
Freeman	Minority position is dead money				
Friedlob (79)	—	—	—	—	—
Friedlob (83)	—	—	—	—	—
Gelman	< 15- > 40	33.0	—	—	—
Guenther	25-30	27.5	—	—	—
Harper/Lindquist	—	—	—	—	—
Horsman	—	—	—	33-⅓	—
The Business Owner	—	—	30-50	40	—
Longenecker	25-35	—	20-30	—	—
Lyons/Wilczynski	35-40	37.5	27-28	27.5	—
Lyons/Whitman	cited 20-30	—	—	cited 16.0	—
Maher (76)	14-75	35.0	—	—	—
Maher (79)	—	—	—	16.1	—
Moroney (73)	14-90	36.3	—	—	—
Moroney (77)	25-100	50.0	—	—	—
Pittock/Stryker	7-91	45.0	—	—	—
Revenue Ruling 77-287	—	—	—	—	—
Rogow/Lloyd/Hand	—	—	—	—	—
	4-100%	42.02%	15-78%	29.63%	48.5%

Average non-marketability discount 42.02%
Average minority position discount 29.63%

Total discounts 71.65%

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FAMILY LIMITED PARTNERSHIP

(FLP)

- Principal Vehicle to Obtain Discounts

- Definition of "Partnership"

- Converting a Desirable Asset Into An Undesirable Asset

  - A, B and C Form an Entity

    - Minority Interest Discount

    - Marketability Discount

    - Concept of Discounted Cash Flow

  - Choice of Entity

FAMILY LIMITED PARTNERSHIP

THE JOHN AND MARY DOUGH
FAMILY LIMITED PARTNERSHIP

I
I
I

JOHN DOUGH = 1% GENERAL PARTNER

MARY DOUGH = 1% GENERAL PARTNER

JOHN DOUGH = 49% GENERAL PARTNER

MARY DOUGH = 49% GENERAL PARTNER

GENERAL PARTNERS HAVE ALL THE CONTROL AND ARE PERSONALLY LIABLE

LIMITED PARTNERS HAVE NO CONTROL AND ARE NOT PERSONALLY LIABLE

DIFFERENCE BETWEEN ESTATE TAX AND GIFT TAX

- Tax Inclusive vs. Tax Exclusive
  - Estate Tax — Pay Tax on the Tax
  - 122% — 55%—27½% Bracket [Examples to Follow]
- Appreciation — 7.2% Per Year for 10 Years — Tax is 244% of Original Value
- Impact of GSTT — $4,938,272 Needed to Pass on $1,000,000
- In Whose Hands Is the Property Valued?
  - Estate Tax — What Decedent Owned at Death
  - Gift Tax — Measured by What Each Donee Receives
  - Rev. Rul. 93-12
  - Assume 50% Discount — 27½% Bracket

DIFFERENCE BETWEEN ESTATE TAX AND GIFT TAX

- **Example #1:**

  - **Want to Transfer $1,000,000 Business at Death**

$2,222,222	**Needed in Estate**
X 55%	**Tax Rate**
$1,222,222	**Estate Tax Paid to IRS**
$1,000,000	**Business to Children**

  - **TAX IS 122% OF VALUE OF BUSINESS**

DIFFERENCE BETWEEN ESTATE TAX AND GIFT TAX (Cont'd.)

- **Example #2:**

  - **Want to Transfer $1,000,000 Business By Gift**

$1,000,000	**Business to Children**
X 55%	**Tax Rate**
$ 550,000	**Gift Tax Paid to IRS**

  - **TAX IS 55% OF VALUE OF BUSINESS**

DIFFERENCE BETWEEN ESTATE TAX AND GIFT TAX (Cont'd.)

- **Example #3:**

  - **Want to Transfer $1,000,000 Business in Non-controlling Interests to Children**

  - **Assume a 50% Valuation Discount**

$1,000,000	**Business to Children**
$ 500,000	**Gift Tax Value After Valuation Adjustments**
X 55%	**Tax Rate**
$ 275,000	**Gift Tax**

  - **TAX IS 27.5% OF VALUE OF BUSINESS**

ESTATE/GIFT TAX VARIATIONS –

TRANSFER TAX ADVANTAGES OF GIFTING

Tax Inclusive vs. Tax Exclusive. The estate tax is a tax inclusive tax, while the gift tax is a tax exclusive tax. For estate tax purposes, the tax is imposed on both the property transferred and the tax itself. In contrast, the gift tax is imposed only on the value of the property transferred.

Under the estate tax, $1,000,000 subject to tax in the 55% bracket would result in a $550,000 tax and $450,000 passing to the beneficiary, a tax of 122% on the transferred property.

Under the gift tax, using the same $1,000,000, a transfer of $645,000 could be made to the beneficiary resulting in a tax of $355,000.

In Whose Hands Is the Property Valued? See, Pennell, "Valuation Discord: An Exegesis of Wealth Transfer Tax Valuation Theory and Practice," U. Miami 30th Inst. on Est. Plan., Ch. 9 (1996). Another major variance between the estate and gift taxes is illustrated by the facts of Rev. Rul. 93-12. In that ruling, 20% gifts of stock were made to each of the donor's five children. Each gift was valued as a separate minority interest gift. Had the same transfers taken place at death, because the decedent owned 100% at death, the stock value for transfer tax inclusion purposes would not have received a minority interest discount.

For estate tax purposes, the asset is valued by determining the decedent's interest in the property irrespective of its destination.

The estate tax is an excise tax on the privilege of transferring property. For purposes of computing the gross estate, the tax is imposed upon what the decedent owned at death without regard to the fact that the asset may be fragmented and passed to several beneficiaries. "The estate tax is a tax...imposed on the privilege of transferring property, not a tax on the privilege of receiving property." Ahmanson Foundation v. United States, 674 F.2d 761, 768 (9th Cir. 1981).

For gift tax purposes, the value of interest transferred is determined by what a hypothetical willing buyer would pay for it. United States v. Land, 303 F.2d 170 (5th Cir. 1962). The gift is measured by what each donee receives rather than the aggregate of all transfers made by the donor. Rev. Rul. 93-12.

"Unlike the estate tax where the tax is imposed on an aggregation of all the decedent's assets, the gift tax is imposed on the property passing from the donor to each donee and it is the value of that property passing from the donor to the donee that is the basis for measuring the tax. Thus, where a donor makes simultaneous gifts of property to multiple donees, the gift tax is imposed on the value of each separate gift." TAM 9436005.

Example: Assume an estate owner is in a 55% marginal transfer tax bracket and wants to transfer a business worth $1,000,000 to the estate owner's five children. The following will illustrate the significant savings which can be derived by taking advantage of the benefits of a current gifting program as contrasted by holding the property until death.

(a) Estate tax route — bequest of five 20% interests to the children:

$2,222,222	-	included in taxable estate
(1,222,222)	-	estate tax
$1,000,000	-	net to children

The tax is 122% of the value of the property transferred. If the business grew at 7.2% a year for 10 years, it would double in value, requiring that the $4,444,444 be in the estate in order to pass on the business to the children. The tax would be 244% of the original value of the business.

(b) Gift tax route — transfer to one beneficiary illustrating tax inclusive vs. tax exclusive:

$1,000,000	-	gift
550,000	-	gift tax
$1,550,000	-	amount needed to make gift

The tax is 55% of the value of the property transferred.

(c) Gift tax route — gift to five children combining valuation discounts (assume 50%) with tax inclusive vs. tax exclusive concept.

$500,000	-	gifts (five 20% interests receiving 50% discounts)
275,000	-	gift tax

The tax is 27.5% of the value of the property being transferred. Since all the growth will inure to the benefit of the donees, the gift tax will be 11.25% of the estate tax, which will be paid on the appreciated values of the business if death occurred in 10 years. ($275,000 vs. $2,444,444)

Impact of Generation Skipping Transfer Tax ("GSTT"). Significant additional benefits can be derived by transferring the property into a trust exempt from the GSTT. A "defective" exempt trust will leverage the benefits even further.

Caveat: A non-exempt trust can have an extremely punitive result.

Example: Suppose an estate owner wishes to pass the business in trust to a child for life with remainder after the death of the child to a grandchild. Assume that there is no appreciation (otherwise, the problem would be accentuated) and that the estate owner's $1 million GSTT exemption has already been used. The estate owner would need to start with $4,938,272, computed as follows:

$4,938,272	-	in donor's taxable estate
(2,716,050)	-	FET at 55%
$2,222,222	-	net to trust

The distribution to the grandchild is "tax exclusive," similar to the estate tax. Therefore:

$2,222,222	-	taxable termination subject to GSTT
(1,222,222)	-	GST tax
$1,000,000	-	to grandchild net of all transfer tax[4]

[4]See Professor Stanley M. Johanson's (of the University of Texas) excellent outline, "Estate Planning for the Very Rich."

PLANNING IN THE REAL WORLD

- What Does A Closely Held Business Really Represent?
- Most Clients Do Not Want to Part With Control
- Most Clients Do Not Want to Pay Any Substantial Gift Tax
- Dual Objectives
  - Take Advantage Between Estate and Gift Tax Systems
  - Not Pay Substantial Gift Taxes
- Guaranteeing Success
  - Survivorship Feature
  - Heads I Win — Tails I Win

INTENTIONALLY DEFECTIVE IRREVOCABLE TRUSTS (IDIT)

- Conventional Wisdom — Avoid Grantor Trust Status

- Trusts Usually Taxed as Separate Entities

- Intentionally Violate Grantor Trust Provisions: IRC Sections 671-679

- IDIT — Grantor Is Treated As "Owner" of Trust Property for Income Tax Purposes but Not for Transfer Tax Purposes

    - Grantor, Not Trust, Pays Income Tax On Trust Earnings

    - Rev. Rul 85-13 — IRS Rules That Transactions Between Grantor and Trust Are Ignored

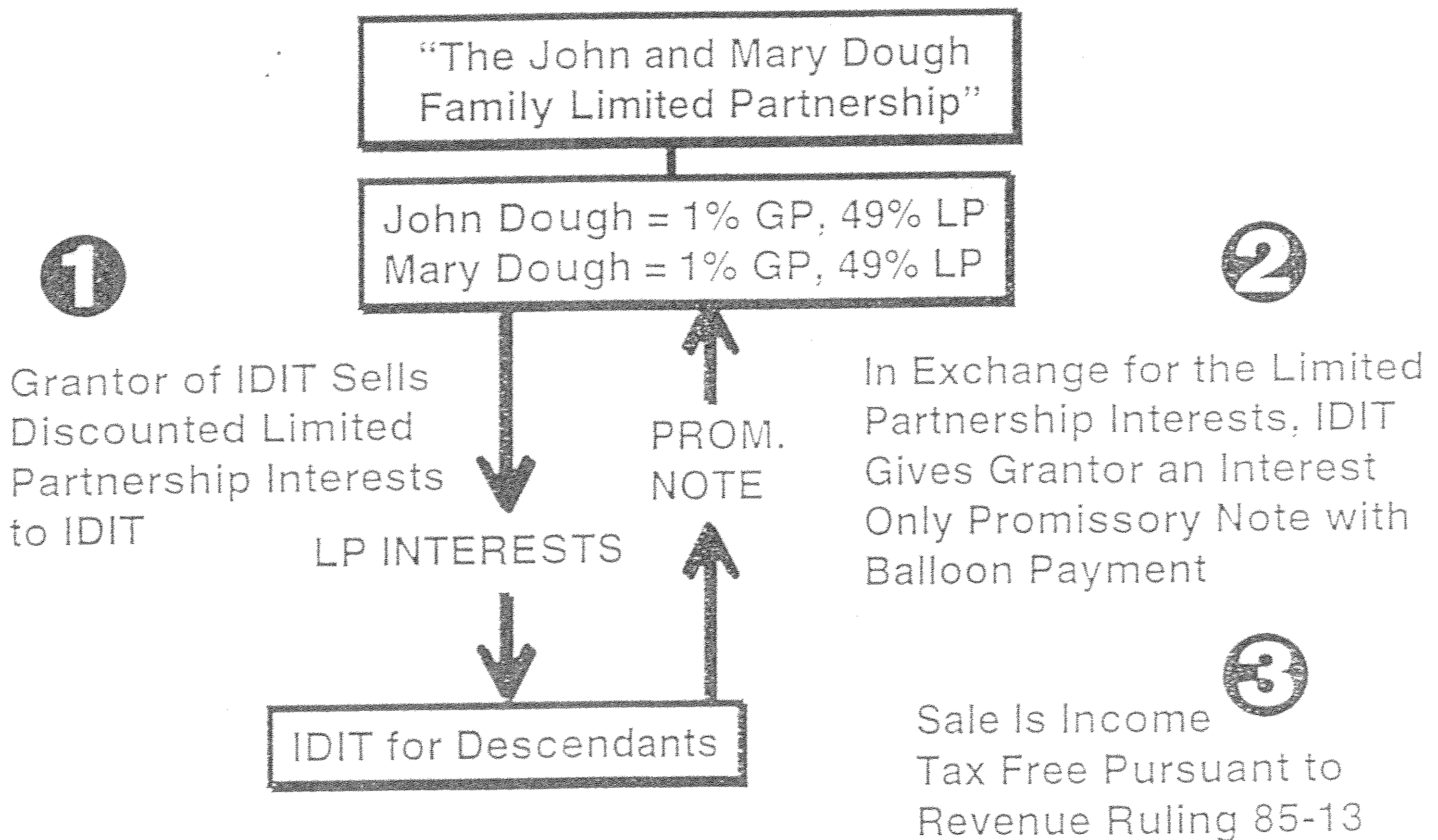
REVENUE RULING 85-13

"Because A is treated as the owner of the entire trust, A is considered to be the owner of the trust assets for federal income tax purposes. . . . In this case, A is considered to be the owner of the promissory note held by the trust. Therefore, the transfer of the Corporation Z shares by T to A is not recognized as a sale for federal income tax purposes because A is both the maker and the owner of the promissory note. A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction." (Citations omitted.) Rev. Rul. 85-13, 1985-1 C.B. 184.

INTENTIONALLY DEFECTIVE IRREVOCABLE TRUSTS (IDIT)

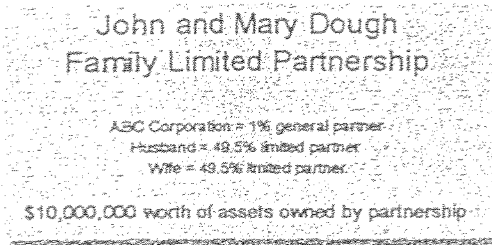
- **Planning — Combine the Concepts We've Learned**
  - **Family Limited Partnership**
  - **Valuation Discounts**
  - **Trusts (Particularly Dynastic Trusts)**
- **EXAMPLE:**
  - **$10 Million Business**
  - **Income 10% Per Annum**
  - **Sell 40% Interest to IDIT**
  - **50% Valuation Discount**
  - **Promissory Note: Interest Only Plus Balloon**

Sale to IDIT - Flow Chart

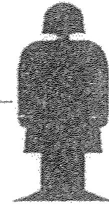


SALE OF LIMITED PARTNERSHIP INTERESTS TO A "DEFECTIVE" MEGATRUST

1(a). Husband puts $5,000,000 worth of assets in FLP in exchange for partnership interests.



1(b). Wife puts $5,000,000 worth of assets in FLP in exchange for partnership interests.

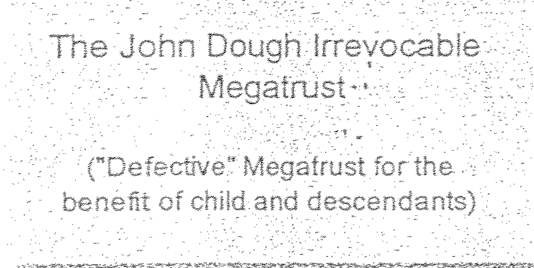


INTEREST-ONLY SALE WITH BALLOON PAYMENT

*The assets are put into the FLP before the sale so that Husband and Wife can take advantage of minority interest and lack of marketability discounts inherent in transfers of limited partnership interests.

2. Husband makes a small gift of cash or other assets to the Megatrust prior to the installment sale. This is done in order to reduce the chance that the installment sale would be deemed a sham.

3. Assume Husband transfers limited partnership interests to the Megatrust in exchange for a promissory note to be paid interest-only for a term of years with a balloon payment at the end of the term.



*Assets can be sold to a "defective" trust (ie. a grantor trust for income tax purposes) by the grantor without any capital gains or ordinary income tax since the grantor is the "owner" of the trust for income tax purposes. Rev. Rul. 85-13. Since Husband is the owner of the trust, he pays taxes on income earned by the trust and he gets the benefit of all deductions and credits attributible to the trust. IRC Section 671.

How will the sale be structured? The sale will be structured as an interest-only sale for a term of years with a balloon payment at the end of the term and a right of prepayment without penalty. Interest will be paid annually at the IRC Section 1274(d) rate. Husband will transfer limited partnership interests to the "defective" Megatrust in exchange for a promissory note. Each year when the interest payment on the promissory note is due, the Megatrust will transfer cash (and/or other assets which may be limited partnership interests) to Husband. The transfer in kind is not taxable for income tax purposes since it is a transfer from a "defective" trust. At the end of the term of the promissory note, the Megatrust will transfer the balloon payment in cash (and/or other assets which may be limited partnership interests) to Husband.

ASSUMPTIONS: Sale of 40% limited partnership interest; FLP owns $10,000,000 in assets producing 10% income/growth; 40% limited partnership interest has pro rata value of $4,000,000; limited partnership interests discounted 50%; discounted value of 40% interest is $2,000,000; interest-only promissory note at 7% interest with balloon payment made at beginning of year 10; computation does not include initial gift to trust nor the growth thereon.

YEAR	BEGINNING OF YEAR AMOUNT IN MEGATRUST	10% INCOME/GROWTH (10% OF COLUMN 1)	7% INTEREST PAYMENT (7% OF $5,000,000)	REAL VALUE TO FAMILY END OF YEAR IN MEGATRUST
0	$4,000,000	$400,000	$140,000	$4,260,000
1	$4,260,000	$426,000	$140,000	$4,546,000
2	$4,546,000	$454,600	$140,000	$4,860,600
3	$4,860,600	$486,060	$140,000	$5,206,660
4	$5,206,660	$520,666	$140,000	$5,587,326
5	$5,587,326	$558,733	$140,000	$6,006,059
6	$6,006,059	$600,606	$140,000	$6,466,665
7	$6,466,665	$646,667	$140,000	$6,973,332
8	$6,973,332	$697,333	$140,000	$7,530,665
9	$7,530,665	$753,066	$140,000	$8,143,731
10	$8,143,731 minus $2,000,000 balloon payment = $6,143,731 in Megatrust			

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BENEFITS OF SALE TO IDIT

- Estate Tax Savings
  - Converts Interest From Part of a Control Block
  - Note Worth Discounted Fair Market Value Is In the Estate
- Interest in Entity Sold Is Frozen — Leaky Freeze
- No Income Tax — Rev. Rul. 85-13
- Leveraging of $1 Million GST Exemption
- By Paying Tax, Grantor Making Functional Equivalent of Tax-free Gift
- Paying Tax Reduces Grantor's Estate
- Cure Poorly Drafted Trust

GRANTOR RETAINED ANNUITY TRUST (GRAT)

- A GRAT Is An Irrevocable Trust In Which the Grantor Makes a Gift and Retains An Annuity for a Term of Years

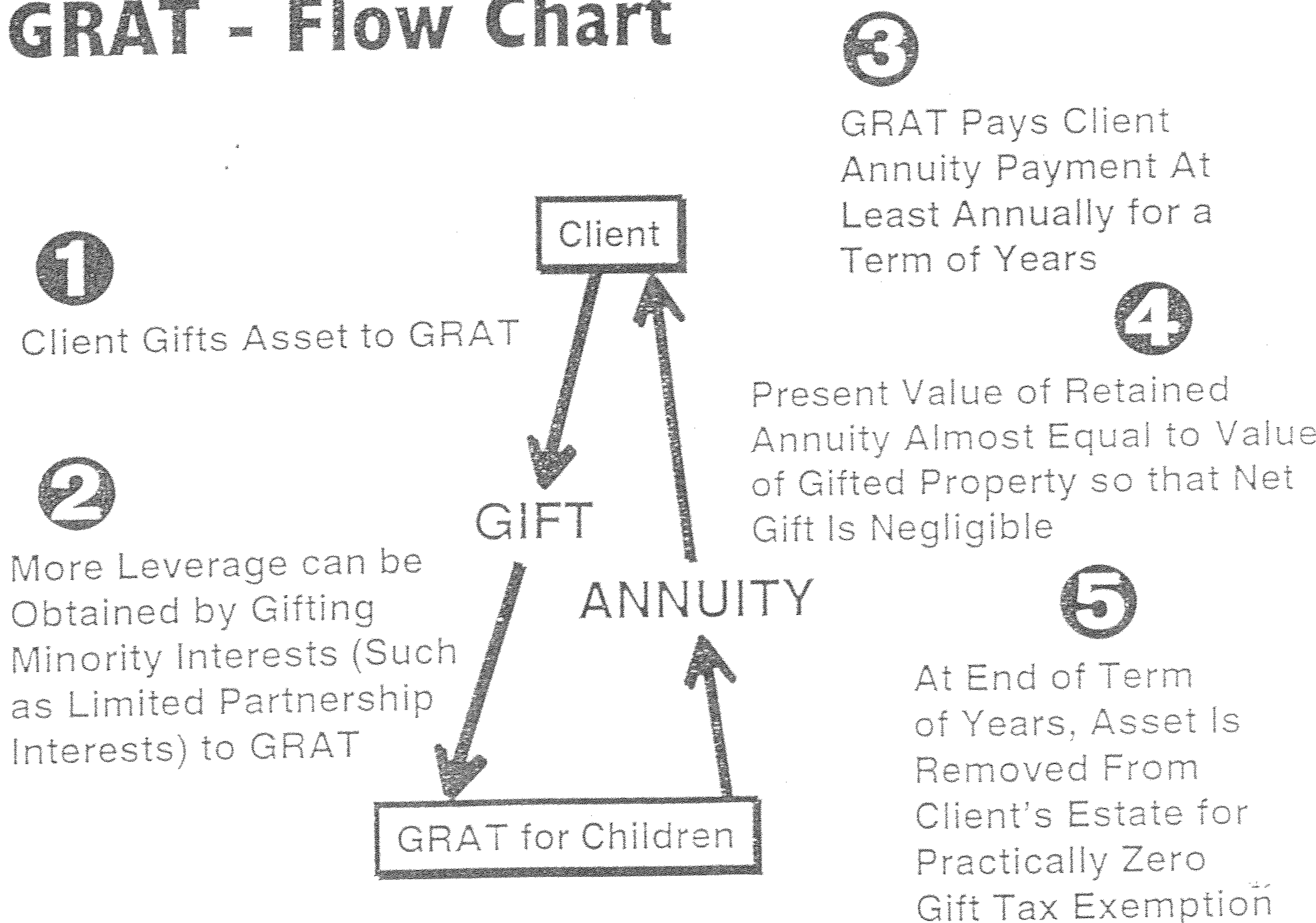
- Value of the Gift for Gift Tax Purposes Is the Value of the Asset Transferred to the Trust Minus the Present Value of the Retained Annuity

- Structure the Retained Annuity So Its Value Is Almost Equal to the Value of the Transferred Asset — Therefore, the Gift Is Close to Zero

- Transaction Is Very Similar In Structure to the Sale to an IDIT Technique

- Limitation: No Generation-Skipping

GRAT - Flow Chart



COMPARISON OF NOTE SALE TO IDIT VS. GRAT

- Interest Rate in Structuring Transaction — Favors IDIT
  - IDIT — IRC §1274 — e.g., 3-9 Years Federal Midterm Rate
  - GRAT — IRC §7520 — 120% Federal Midterm Rate
  - Lower the Rate — Less to Grantor — More Taxfree to Beneficiaries

- Survivorship Feature — Favors IDIT
  - GRAT — Must Survive Term or Trust Assets (Including Post-Transfer Appreciation) In Taxable Estate
  - IDIT — Only Value of Note in Estate. Post-Sale Appreciation Escapes Transfer Tax

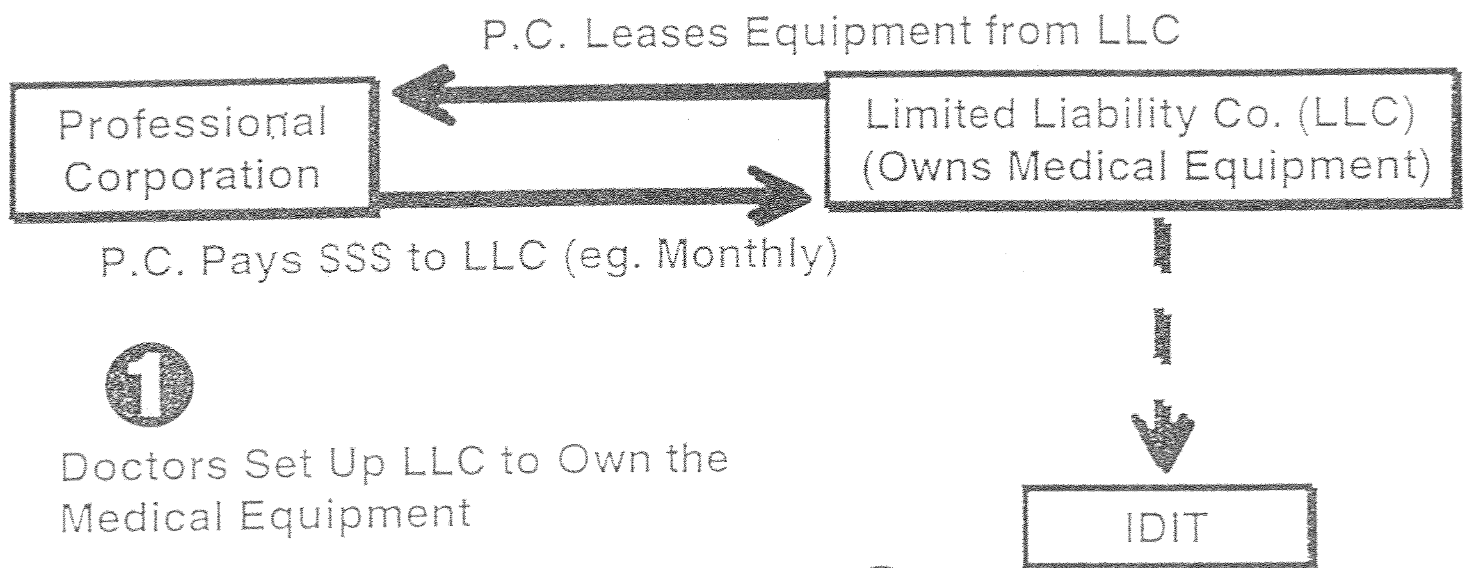
- GSTT — ETIP (Estate Tax Inclusion Period) — Favors IDIT
  - IDIT — Immediately GSTT Exempt
  - GRAT — Can Only Allocate At End of Term — Inefficient for GSTT Planning — Unless Remainderman Sells Remainder Interest

- **Taxable Gift — Favors IDIT**
  - GRAT — Gift — Example 5 of Treas. Reg. §25.2702-3(e) — Rev. Rul. 77-454
  - IDIT — No Gift Involved — Sale for FMV

- **Payment Structure — Favors IDIT**
  - IDIT — Note Structure Flexible, All Principal Can Be Back Loaded, Right to Prepay
  - GRAT — Annuity Payments Cannot Exceed 120% of Amount Paid During Preceding Year, Payments Fixed at Inception
  - By Delay, Income or Growth on Retained Payments Inure to Trust Rather Than Grantor

- **Gift Tax Exposure — Favors GRAT**
  - IDIT — If Note Less Than FMV, Gift Made
  - GRAT — Can Finesse Gift Tax by Expressing Annuity As Percentage of FMV

Sale or Gift and Leaseback



2

Professional Corporation Leases Equipment From LLC for Fair Market Rental Value

3

Doctors Each Set Up IDIT and Gift and/or Sell Discounted LLC Interests to the IDIT

SALE OR GIFT AND LEASEBACK ADVANTAGES

- **Medical Equipment Is Protected From Creditors of the Professional Corp., Doctors and Trust Beneficiaries**

- **Equipment Is No Longer Part of Taxable Estate**

- **Equipment Lease Is Ideal for Installment Sale Technique**

- **Ability to Continue to Use the Equipment**

OPPORTUNITY SHIFTING

- **Shifting the Opportunity to Generate Wealth**

- **Large Wealth From Little "Seed" Money**

- **Referrals and Advice Are Not Taxable Events**

- **Estee Lauder — Aramis and Clinique**

- **Other Examples: (1) Auto Dealers, (2) Manufacturers, (3) Store Owners — New Locations, (4) Builders and (5) Equipment**

- **Look Up A Generation — "Advance on My Inheritance"**

Opportunity Shifting - Flow Chart

➊

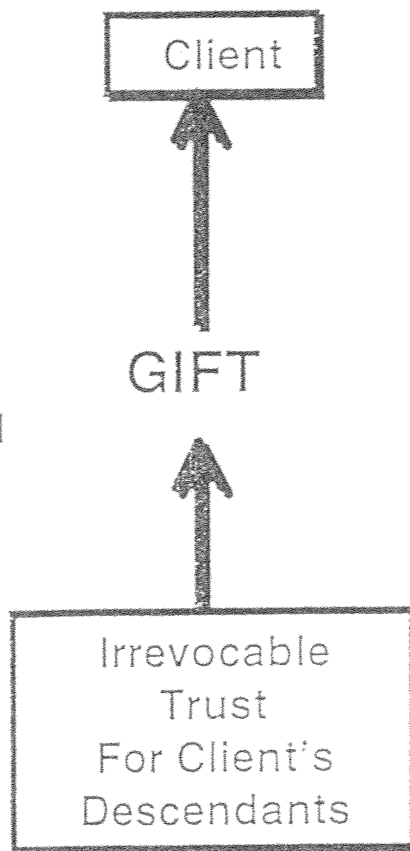
Successful Business Owner / Client Wants to Open a New Location for Client's Business

➋

Another Successful Business Location Will Create Further Estate Tax Problems When Client Dies

➌

Client Sets Up an Irrevocable Trust for Client's Children (and Spouse if Desired)



➍

Client Gifts Enough Money to the Trust to Start the Business

➎

Because the Trust Owns the Business, the Business and All of its Growth and Income Are Not Included in Client's Estate, Client's Spouse's Estate or Client's Children's Estates, etc...

"CRUMMEY" — "DEFECTIVE": EXTREMELY EFFECTIVE

- Planning — Combine the Concepts We've Learned
  - Defective Dynastic Trusts
  - Wealth Shifting Strategies
    > Opportunity Shifting and/or
    > IDIT — Note Sale and/or
    > Lease Arrangements

- Defective As To Beneficiary
  - IRC §678 Person Other Than Grantor Treated As Owner
  - Effect of "Crummey" Power
    > Grantor Does Not Violate Grantor Trust Rules
    > Dual Violations — IRC §678(b)
    > Effect of Cessation of Dual Violations LTRs 9026036; 9321050

- Pipe Dream Realized

- Don't Mix Apples and Oranges (LTR 9034004)

- Look Up A Generation

"CRUMMEY" -- "DEFECTIVE"

IRC §678 states:

"Sec. 678. PERSON OTHER THAN GRANTOR TREATED AS SUBSTANTIAL OWNER.

(a) GENERAL RULE. -- A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person 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 sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

(b) EXCEPTION WHERE GRANTOR IS TAXABLE. -- Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section." (Emphasis supplied.)

Effect of "Crummey" power. An example of the IRS's ruling position is found in LTR 9311021, where it stated:

"The primary beneficiary is treated as the owner of that portion of the trust in which his withdrawal right has not yet lapsed under section 678(a)(1) of the Code, because of his ability to withdraw any additions to the trust. In addition, upon the lapse of the withdrawal power the primary beneficiary still has a section 675(4)(C) power over the trust property because he may, at his option, exercisable in a non-fiduciary capacity, acquire all or any part of the property of the trust by exchanging for it property of equal value. Thus,

under section 678(a)(2), the primary beneficiary is also treated as the owner of the trust property for which his withdrawal power has lapsed. Therefore, the primary beneficiaries, A, B, and C, are treated as the owners of their entire trust, Trust A, Trust B, and Trust C, respectively, under section 678."

Don't Mix Apples and Oranges, or you'll have an accounting nightmare.

"During each succeeding year in which A fails to exercise her power, A will be treated as the owner of an increasing portion of corpus of T. For purposes of determining the increase in her deemed ownership her current withdrawal power for any particular year will cause an increase in the amount of corpus which she is treated as owning equal to the product of the amount which she could withdraw multiplied by a fraction the numerator of which is the portion of trust corpus which she is not already treated as owning and the denominator of which is the total of trust corpus from which the withdrawal could be made. Discretionary distributions made by the trustee from corpus will be treated as coming from both the portion of corpus which the beneficiary is treated as owning and from the portion which she is not treated as owning in the same ratio as the fraction mentioned above." LTR 9034004.

This position is summed up by Professor Jeff Pennell, of Emory Law School, as follows:

"Computing the Tax Consequences of Lapsing Five or Five Withdrawal Rights. Private Letter Ruling 9034004 illustrates the government's position on the proper computation of the income tax consequences of the lapse of a five or five withdrawal right. Citing Revenue Ruling 67-241, 1967-2 C.B. 225, for the proposition that the powerholder is treated as the owner of a portion of the trust in the year the power is exercisable, the Ruling holds that lapse of the withdrawal power is tantamount to a release for purposes of section 678(a)(2). If the powerholder is entitled to trust income in future years, this release generates grantor trust exposure for the duration of the trust and, according to the Ruling, this exposure increases every time a withdrawal power lapses. Thus, the government will not treat a new lapse as occurring

with respect to the same five or five portion every year. Instead, the increase in the portion subject to grantor trust treatment attributable to a new lapse is computed according to a formula:

Increase = <u>withdrawable amount X trust portion not yet owned</u>
total trust corpus

To illustrate the computation, assume the taxpayer may withdraw five percent of the trust corpus every year. In year 1 the owned portion would be 5% x 100%/100% = 5%. The year 2 increase would be 5% x 95%/100% = 4.75% and a total of 9.75% would be deemed owned by the powerholder. The year 3 increase would be 5% x 90.25%/100% = 4.5125% and a total of 14.2625% would be deemed owned by the powerholder. In year 4 the increase would be 4.286875% and the owned portion would increase to 18.549375%, and so on. Under this approach the trust never would become totally owned no matter how long the withdrawal power existed and lapsed, although the owned portion eventually would approach 100%. The government's computation is equitable but complicated and the Ruling underscores the notion that the lapse of a five or five withdrawal power is <u>not</u> harmless for income tax purposes the way it appears to be under section 2514(e) for most wealth transfer tax purposes." Pennell, "Recent Wealth Transfer Tax Developments Parts One & Two," 1991 CPE Est. Plan. Update Jan./Feb. 1991, p. 98.