Course Objective

This course was created to teach advisors (CPAs, EAs, accountants, attorneys, financial planners, and insurance advisors) about the "advanced" estate planning tools that can be used to help high net worth clients. Most advisors are aware of wills, trusts, durable powers, and irrevocable life insurance trusts. This material was created to discuss topics that are mainly used by the best and most sophisticated estate planning tax attorneys in the country.

This material, once learned, will open up a new area of consulting for many advisors who, to date, have not felt comfortable approaching $5,000,000-$25,000,000+ net worth clients for their business.

"Advanced" Estate Planning

Family Limited Partnerships

Family Limited Partnerships (or Family Limited Liability Companies) can present substantial planning opportunities for wealthy families. Although challenged by the Internal Revenue Service (the "IRS") in recent years, when properly utilized in a high net worth individual's or wealthy family's estate planning, a Family Limited Partnership ("FLP") can provide substantial tax and non-tax benefits. Benefits include but are not limited to:

1) Providing a centralized vehicle through which the family cannot only manage a portion of its wealth but also provide a governance structure through which the younger generation can learn the art of running a family business (if the FLP holds an existing family business) from the senior generation. It can also provide an environment for the senior generation to teach the nuances of managing the family's wealth to the successors;

2) Providing a level of protection against potential creditor claims;

3) Increasing the efficiencies of both costs and administration of the family's wealth;

4) Enhanced wealth-transfer planning due to valuation discounts which may be applied to gifts or sales of limited partnership interests to family members or to trusts established for their benefit (see the upcoming section on sales to "Intentionally Defective Grantor Trusts."); and

5) Income and cash-flow planning across multiple generations.

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Overview

An FLP is a separate legal entity created under state law by filing a Certificate of Limited Partnership (or the home state equivalent, depending on the jurisdiction). An FLP is classified as a partnership for federal income tax purposes and, therefore, is subject to taxation only at the partner level.

Each partner is taxed according to their pro-rata ownership interest in the FLP, which means that all of the income, expenses, gains, and losses "flow through" to each partner in proportion to the ownership percentage in the FLP. In addition to the Certificate of Limited Partnership, the FLP is governed by the Family Limited Partnership Agreement. This is a legal document executed by the partners that sets forth all of the terms and conditions of the administration, management, and governance of the FLP. It also details each partner's rights with respect to withdrawal from the partnership or the ability to transfer a partner's interest in the FLP to another individual or family member. *Family Limited Partnership Agreements are sophisticated legal documents that require specialized drafting to ensure that the terms and conditions of the FLP will be respected by the IRS.*

There are special tax rules that must be followed in creating the FLP. In this regard, Section 721 of the Internal Revenue Code (the "Code") generally provides for non-recognition of gain or loss upon the contribution of assets to the FLP. Despite this general rule of non-recognition, however, special attention should be afforded when there will be multiple partners in the FLP who are contributing marketable securities to the FLP.

Care must be taken to ensure that the FLP does not fall prey to the "investment company" rules, which would trigger severe adverse tax consequences. While beyond the scope of this discussion, if an FLP is being formed by several individuals, each of whom is contributing a diversified basket of marketable securities, it should be noted that the IRS can challenge the tax-free formation of the FLP on the basis that the partnership was formed primarily to allow the individuals to diversify their investment portfolios. In such a circumstance, the built-in gains in the portfolios contributed to the FLP may be recognized by and become taxable to the contributing partners on the date of contribution.

As a practical matter, however, this should not be an issue in the family context. Because a married couple typically forms an FLP and since a husband and wife are considered to be a single individual for purposes of applying the investment company rules, the contribution of the marketable securities to the FLP should qualify for non-recognition treatment.

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Typically, an FLP has two categories of partners (although it can have more):

(1) A general partner or partners who maintain control over the management and administration of the partnership, and

(2) Limited partners who have no involvement in the day-to-day management of the FLP.

The general partners are liable for all of the FLP's obligations, debts, and liabilities; and often individuals create a second entity, such as a trust, corporation, or limited liability company to serve as the general partner to further insulate them from liability. The limited partners are not liable for the debt or obligations of the FLP, and they are not entitled to participate in the day-to-day management of the FLP.

Supercharging an Estate Plan with FLPs

Individuals with assets of substantial value often face the challenge of providing an orderly and smooth tax-efficient transfer of wealth from one generation to the next. This requires dealing with the issue of whether these transfers will trigger enormous gift or estate tax liabilities, which will deplete the overall amount of assets being transferred from one generation to the next. Many wealthy individuals and families are concerned that the family wealth may become subject to creditor claims if outright gifts of property are made to the children or grandchildren. Moreover, wealthy individuals and families oftentimes desire to mitigate the potential for the family's wealth to be put in jeopardy through mismanagement and thus look to advisors to provide an appropriate family governance structure to manage the family's wealth in future years.

In this regard, therefore, an FLP represents a unique solution for a wealthy family to consider. By transferring a portion of the family's assets to an FLP, the **family can maintain control over the income, management, and divestiture of the assets**. In a typical estate plan, a married couple transfers assets to an FLP and, in return, receives both general partnership and limited partnership interests. At some point in the future, the couple will make gifts of the limited partnership interests to their children or grandchildren or to trusts for the benefit of their children or grandchildren. In this way, the family is capable of maintaining the management of the assets in one centralized vehicle and is able to fractionalize the ownership (and the income generated by the assets) among a broader group. This could have the impact of both assisting future wealth accumulation for the next generation in a creditor-protected environment (i.e., through the use of trusts) and also allow for income that would otherwise be taxed in the highest tax brackets (i.e., the senior family member's tax bracket) to be transferred to individuals in a lower tax bracket.

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Supercharged Gifting

A key attribute of FLP planning is the impact that the FLP can have in coordinating a family's gifting strategy. Because the lifetime gift tax exemption provided under the current federal gift tax law is capped at $5,000,000 per individual (every individual is entitled to gift up to $5,000,000 worth or property during his or her lifetime), the ability for individuals to leverage the use of the lifetime gift tax exemption as much as possible has become increasingly important.

No one knows what will happen in 2013 when the gift tax exemption is set to revert back to $1,000,000 per person.

A significant advantage of utilizing an FLP is the opportunity for the senior generation of a family to transfer (either by gift or by sale) **limited partnership interests to the next generation at a discounted value**. Because the limited partnership interests being transferred are typically the **non-controlling** interests and, in some instances, **subject to a number of restrictions** with regard to **transferability**, withdrawal, liquidation, etc., the value of such interests for gift tax purposes is compressed (discounted).

The use of an FLP in connection with a family's overall gift planning allows the family to "supercharge" its gifting due to the fact that the value of the gift for gift tax purposes is the **fair market value of the limited partnership interest** being gifted (taking into consideration all of its negative attributes) and not the underlying assets of the FLP. Thus, because what is being gifted (the limited partnership interest) is most often a **non-controlling**, **unmarketable,** and **nontransferable** (subject to limited exceptions) interest in a family entity, the value of the interest for gift tax purposes is subject to valuation discounts.

Example of a $1,000,000 gift:

A married couple contributes $1,000,000 worth of assets to an FLP and, in exchange, takes a 1% general partnership interest and 99% limited partnership interest. At some point after the FLP is formed and the agreement is executed, the couple gifts all of the limited partnership interests to their children and grandchildren or to irrevocable trusts for the benefit of their children or grandchildren.

Had the couple simply gifted the assets directly, the value of the assets for gift tax purposes would be $1,000,000. Because the assets being gifted are limited partnership interests in the FLP, which conveys **no rights of management or control** in the FLP and **are subject to transfer restrictions**, it is likely that the limited partnership interests would be discounted to reflect these negative attributes.

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If one assumes that a qualified appraiser would value the limited partnership interests as having a 30% discount, then the value of the gift for gift tax purposes would be $700,000 instead of $1,000,000. The use of the FLP has, therefore, *preserved* $300,000 worth of the couple's lifetime gift tax exemption for future transfers.

Keeping it Within the Family

FLPs can ensure that the family's wealth stays in the family. This is so because the FLP Agreement can contain restrictions on the transferability of the FLP interests which will ensure the family that no family member who is a partner (general or limited) can use the FLP interest to satisfy a personal debt; nor can any individual hypothecate, pledge, mortgage, sell, transfer, or assign his or her limited partnership interest **without the consent of the other partners**. This ensures the family that no outside third parties will become partners in the FLP and that the family can control the extent to which transfers of the limited partnership interests are made.

An additional benefit to the FLP structure is that it provides a level of creditor protection for the individual partners. If an individual partner is sued by a creditor, generally the creditor's only recourse is to enforce a charging order against the FLP with respect to that partner's interest. This means that, if the FLP does not make annual distributions to its partners, the creditor may receive nothing in connection with its claim for a long period of time. (For more information about charging orders, please see the educational modules on asset protection)

Managing the General Partner's Liability Exposure

As mentioned earlier, the general partner of the FLP is typically a trust, a corporation, or a limited liability company. The purpose of using a separate legal entity to serve as the general partner is to insulate the general partner from liability exposure with regard to all of the FLP's debts, obligations, etc. As a rule, the general partner or general partners can control the FLP regardless of their percentage of ownership in the FLP.

If a general partner has a 1% ownership interest in an FLP, the other 99% of which is owned by limited partners, will then control 100% of the FLP's activities. The limited partners have no vote or control over the assets of the FLP nor do they have any control over the day-to-day operations or management of the FLP. Limited partners only have the limited rights granted to them by the state limited partnership act and under the limited partnership agreement.

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Estate Tax Issues When the Senior Generation wants to be the General Partner

Recently, the IRS has taken the position that, when an individual establishes an FLP and retains 100% control over the partnership based on his or her retention of the general partner interest, Section 2036 of the Code applies and pulls the assets contributed to the FLP back into the individual's estate for estate tax purposes. Thus, in structuring an FLP, special attention should be paid to who will serve as the general partner and the extent to which the senior generation, who are typically contributing most of the assets to the FLP and gifting the limited partnership interests away, can maintain a level of control over the entity.

The most conservative approach is that the senior generation should, if at all possible, not serve as the general partner. This approach may not be feasible, however. In such a situation, you should consider having an irrevocable trust with an independent third-party trustee (as defined under Section 642(c) of the Code) act as the general partner and provide, within the terms of the trust, the power for the senior generation to appoint and remove the trustee within the confines of Rev. Rul. 95-58, 1995-2 C.B. 1. Another solution might be to have the senior generation establish a corporate general partner (typically, a subchapter C corporation) and retain a minority stake in the entity (i.e., not enough to dissolve the corporation).

The importance of properly addressing this issue at the outset is critical. The IRS has challenged and won in litigation by asserting that the retained power to control the FLP, through the general partnership interest held by the individual who established the FLP, resulted in the assets of the FLP being included in that individual's estate despite the individual having gifted all of the limited partnership interests away. Falling prey to this trap can have dire tax consequences that could be avoided through proper planning.

Limited Partners

The limited partners of an FLP tend to be either individual family members or trusts created for the benefit of the family members to which the limited partnership interests have been transferred, gifted, or sold. Generally, these include an individual's revocable living trust and/or certain types of irrevocable trusts established for children or grandchildren.

An attractive attribute of the FLP is its flexibility of use in connection with number of different types of family holdings and assets that can be contributed to it. There are very few types of assets that cannot (or should not) be transferred to an FLP to take advantage of the FLP's wealth transfer planning advantages. FLPs can be used to:

(1) Operate a family business;

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(2) Hold the stock or assets in the family business;

(3) Hold rental real estate or other income producing property;

(4) Hold marketable securities or other portfolio assets; and

(5) Hold other tangible or intangible personal property,

FLPs cannot, however, hold stock in a subchapter S corporation because the FLP is not a qualified shareholder under the subchapter S corporation rules of the Code and would jeopardize the corporation's subchapter S status. Finally, as a general rule, personal residences or vacation homes should not be transferred to the FLP.

Estate Planning with FLPs: What's all the Hubbub About?

IRS Challenges

Although probably a topic large enough to warrant its own separate chapter, it should come as no surprise that FLPs have been, and continue to be, a heavily litigated area of estate planning. The IRS has attacked the use of FLPs in an effort to negate their planning benefits under two broad lines of attack:

(1) Challenges to the legal status, business purpose, and operations of the FLP, and

(2) Statutory challenges under Sections 2036 and 2701–2704 of the Code.

A significant amount of litigation has recently been seen involving the IRS's use of Sections 2036(a)(1) and (2) of the Code as a means to challenge FLPs. Sections 2036(a)(1) and (2) provide as follows:

General rule. The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life, or for any period not ascertainable without reference to his death, or for any period which does not, in fact, end before his death.

(1) The possession or enjoyment of, or the right to the income from, the property, or

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(2) The right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

While the discussion on any one of the tactics used by the IRS could fill many pages, the following will provide a thumbnail sketch of FLP planning and provide advisors with a sense of the "dos and don'ts" involved in implementing such a strategy. The author acknowledges that this section is not intended to be a recitation of these Code sections but rather a summary of the positions taken by the IRS that should provide some insight for advisors regarding the use of an FLP as part of a client's wealth transfer planning. In any event, an advisor considering recommending an FLP should review the cases cited in the various footnotes as well as the relevant statutory authority and rulings in light of the fast-changing legal landscape concerning FLPs.

Challenges to the Legal Status and Operations of FLPs: Respecting the Entity

For the FLP to be respected by the IRS and not disregarded as simply a vehicle with no other purpose than to provide tax advantages, the FLP must have **a valid business purpose and economic substance**. The sole purpose for the FLP cannot be to simply apply discounts to gifts of the FLP interests.

Several purposes may be used to satisfy the business purpose requirement, including, but not limited to, the use of the FLP to pool assets for investment purposes, centralizing the management of the investments, creating increased efficiencies with regard to the costs of administration of the assets, including illiquid or unmarketable assets, and providing a level of creditor protection for the family's assets. Although most carefully drafted FLP agreements state these reasons and others as the purposes for forming the FLP, the IRS has routinely litigated this issue arguing that the FLP should be disregarded because it is a sham with no other purpose than to provide a tax benefit.

Courts, however, have consistently disagreed with the IRS's position that the FLP, in and of itself, should be disregarded. For example, in *Estate of Strangi v. Commissioner, 115, T.C. (2000), aff'd on other this issue sub nom, Guilig v. Commissioner, 293 F.3d. 279,* despite the fact that the court did not recognize the validity of various non-tax reasons put forth for a decedent's FLP, the court, nevertheless, stated that the FLP was validly formed under state law, and, therefore, should be recognized for tax purposes. In fact, in *Estate of Dailey v. Commissioner, T.C. Memo 2002-31*, the court not only concluded that the partnership should be respected for tax purposes but also concluded that the IRS's position in challenging the validity of the FLP was not justified.

Equally as important as having a valid business purpose for the FLP is the need for families who establish an FLP in connection with their estate planning to respect the formalities of the FLP. The FLP should be operated and

administered like a partnership and not as an alter ego of the founders. It is important that the FLP make distributions on a pro-rata basis to the partners, and; typically, the general partner of the FLP should make distributions of the FLP's net cash flow (the cash not needed to run the business). In so doing, maintaining and respecting the operations of the FLP will help counter the IRS's challenges under Sections 2036 and 2701 of the Code.

Furthermore, the family should **not commingle assets** with the FLP and should not allow one partner to operate the FLP as if the assets held by the FLP were his or her own personal assets. In other words, members of an FLP should not use the assets as if they were owned individually and should not use the FLP bank account as a personal checking account.

Once the FLP is created, each partner is entitled to a share of the income based on his or her pro-rata ownership of the FLP. When the senior generation that established the FLP gifts its FLP interests to the next generation, it should respect the new ownership structure and make FLP distributions in accordance with that structure. No disproportionate distributions should be made to any one partner, and the senior generation should not expect to have access to the assets contributed to the FLP in the same manner that it did prior to contribution.

In cases where this concept has been violated, the IRS has argued successfully that an "implied agreement" existed between the senior generation and the next generation regarding to the use and control over the assets of the FLP; that is, there was an implied agreement that the use and context were not to change post contribution. Thus, the IRS argued, the assets should be included in the senior generation family member's estate under Section 2036.

Early in the planning process, attention should be given to the amount of assets that should be transferred to the FLP by the senior generation. It is **not** prudent to have an individual contribute all of his or her assets to the FLP and, thus, be left with an insufficient amount of wealth outside of the FLP to provide financial security after the contribution is made.

It should be noted that in several cases in which the decedent transferred most, if not all, of his or her assets to the FLP, the court viewed the transfer of such extraordinary amounts to the FLP as a critical fact in arriving at the conclusion that an implied agreement existed between the decedent and the other partners that the decedent had the right to the income from the assets held by the partnership during the decedent's lifetime and that the creation of the FLP did nothing to change the decedent's relationship with the assets from the manner in which he or she held the assets prior to contribution.

It should also be noted that the FLP should, in fact, be run like a partnership with its own separate bank account and regular meetings. The FLP should not have commingled funds with the senior generation's or any other partner's personal assets. Likewise, the FLP should not hold personal assets, such as a personal residence or vacation home, unless fair market value rent is

paid for its use. The FLP should file its own income tax returns (a federal Form 1065 and the sole equivalent) and pay all returns and taxes (such as property taxes and sales taxes) and should *not* allow the partnership to pay any personal expenses for the partners.

Challenges Involving Gifts of FLP Interests: Respecting the Formalities of the Gifts

The **most common challenge** raised by the IRS with respect to gifts of FLP interests from one generation to the next concerns the **valuation discounts** claimed with respect to the gifted interests or whether the restrictions contained in the FLP Agreement were so broad as to render the transfer ineffective for gift tax purposes. The cases involving valuation discount litigation are numerous; and it should come as no surprise that, where the FLPs had sufficient business purposes and were operated with the appropriate formalities, the IRS has had a tough time in having the discounts claimed by the taxpayer disregarded. This has been the case whether the IRS challenged the overall discount applied to the limited partnership interest transferred or to the underlying assets held by the FLP.

An area where the IRS has won in litigation regarding gifts of FLP interest concerns additional contributions to the FLP made by the senior generation after gifts of the FLP interests have been made. If a partner makes an additional contribution to the FLP, the IRS views such contribution as resulting in an increase in the overall value of the other partners' interests. The additional contribution is recast by the IRS as if the individual making the additional contribution first gifted an undivided interest in the property to each of the other partners, then they contributed it to the partnership. Depending on the type of property involved, this can result in substantially smaller discounts being applied for gift tax purposes. Prior to any additional contributions being made, a careful analysis should be made to determine the most effective way to contribute the property to the FLP to minimize gift tax issues.

"Freeze Partnerships"

An Interesting Planning Opportunity

So where is the next generation of FLP planning headed? While not new, the concept of using a derivation of the traditional FLP appears to be making a comeback. The concept of a "freeze partnership" is again receiving attention as an alternative to the traditional FLP structure.

A "freeze partnership" is a partnership in which there are two classes of interests: a preferred interest and a common interest. The preferred interest is typically limited partnership interest but could be the general partnership interest (in very rare circumstances). The preferred interest is considered "preferred" **because it is entitled to preferred dissolution rights;** the preferred interest holder has a fixed dissolution value based on the value of the property

contributed to the partnership; and preferred income rights, the preferred interest holder is entitled to receive preferred distributions of net cash flow from the partnership equal to a set percentage of the value of the dissolution value.

As a practical matter, preferred interests operate very similarly to preferred stock in a corporation. The "common" interests in the partnership are subordinate to the preferred interests **with regard to dissolution and income rights**, **but the common interest holders tend to have voting and managerial control over the partnership**. The common interest holders will share proportionately in the partnership's income distributions but only to the extent that the preferred interest holders have received the preferred income or dissolution payments.

Example:

A Preferred Family Limited Partnership is formed in which $2,000,000 worth of assets are contributed to the partnership. In return for the contributions, parents retain a **preferred interest** equal to a $1,000,000 dissolution value and a 10% preferred income distribution; the balance of the interests are **common interests** and are either sold or gifted away by the parents to their children or trusts for the benefit of their children.

In this case, the preferred interest is entitled to the first $100,000 of distributable income (i.e., net cash flow). Once this $100,000 is distributed, the balance of the distributable income will be distributed to the common interest holders based on each partner's pro-rata ownership of the partnership. If upon the death of the preferred interest holder the partnership is liquidated, the preferred interest holder's estate will include the full $1,000,000 liquidation value; **but the balance of the assets and all the appreciation from the date of inception would be allocated and distributed to the common interest holders**.

The planning implications of using Preferred Family Limited Partnerships are several:

First, because the liquidation values of the preferred interests are "frozen," the common interests will receive all of the growth and appreciation of the assets held by the FLP. **This can result in substantial amounts of wealth being shifted to the common interest holders**.

Second, since the common interests are subordinate to the preferred interests in many respects, especially with regard to cash flow, it is possible that the **common interests would be subject to valuation discounts** for gift or sale purposes. Thus, depending on the types of assets which the FLP is intended to own, there are substantial planning opportunities to use the preferred and common interest structure to provide significant wealth transfer planning benefits.

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For example, suppose the assets held by the FLP are capable of producing more than the $100,000 of income as set forth in the above example. For argument sake, suppose that the assets held by the FLP produce $150,000 worth of income, thus leaving $50,000 of income remaining after the preferred distribution has been made. Assuming that the FLP would make tax distributions to each of the common interest holders equal to the tax they owe on the $50,000 of income, the balance of the income not distributed could be used to purchase life insurance or other assets to increase the overall value of the FLP.

Thus, if a $1,000,000 life insurance policy could be purchased with the remaining cash in the FLP after the preferred and the tax distributions are made to the preferred and common interest holders and the preferred interest holder died the next day, *all of the assets in excess of the frozen $1,000,000 liquidation value (i.e., the balance of the $1,000,000 of assets and the $1,000,000 of death benefit proceeds) would be allocated to the common interests holders.*

Oftentimes, a preferred limited partnership has multiple classes of interests (i.e., senior preferred, junior preferred, participating common, and non-participating common) and the planning can be very creative. The ability to use the preferred and common interest FLP in connection with a family's overall wealth planning can present substantial planning opportunities.

In the following schematics, keep in mind the following assumptions: the mother capitalized the FLP with $2,000,000, and her son capitalized the FLP with $20,000. The mother is issued a preferred interest representing 49.5% ownership and a non-preferred interest equaling the same 49.5% interest. The son has a 1% non-preferred interest but is the managing member of the FLP. Also assume that the FLP interests receive a 30% discount for the various restrictions put in place via the FLP documents.

In this example, the FLP generates $150,000 in income from investments–$100,000 goes to the mother via her preferred interest, $15,000 is distributed to the son to pay for the taxes on the remaining $50,000 income, and $35,000 stays in the FLP and is used to purchase a life insurance policy for $1,000,000 on the mother's life.

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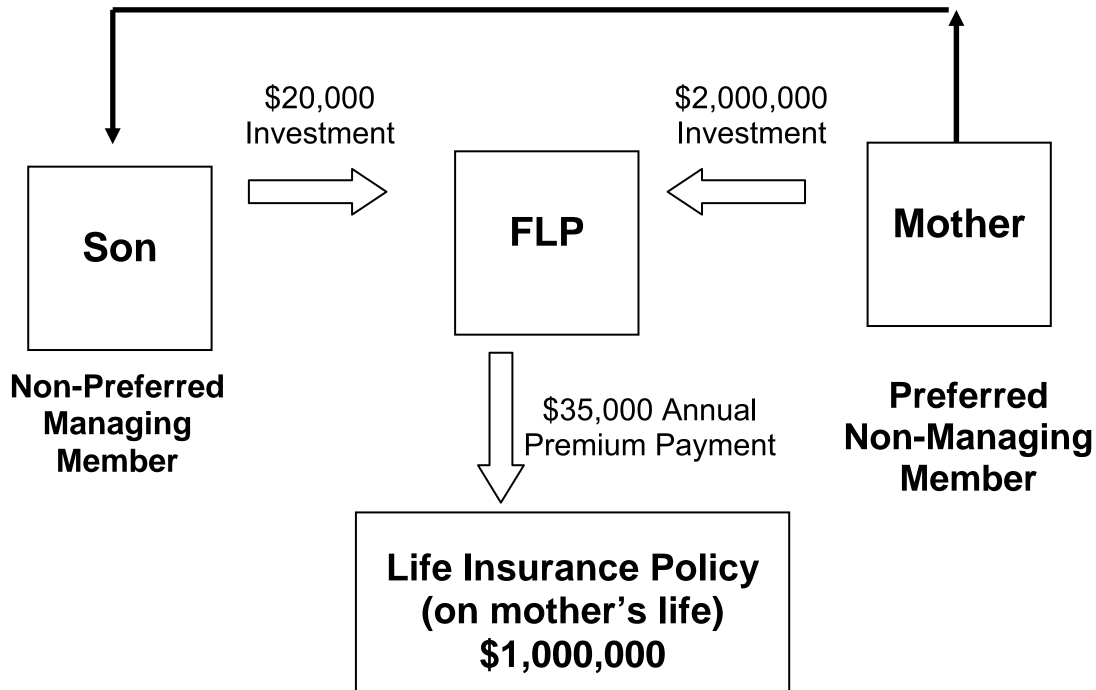
Mother gifts $700,000 in non-preferred interest to son which because of the 30% discount equals her entire 49.5% non-preferred interest.

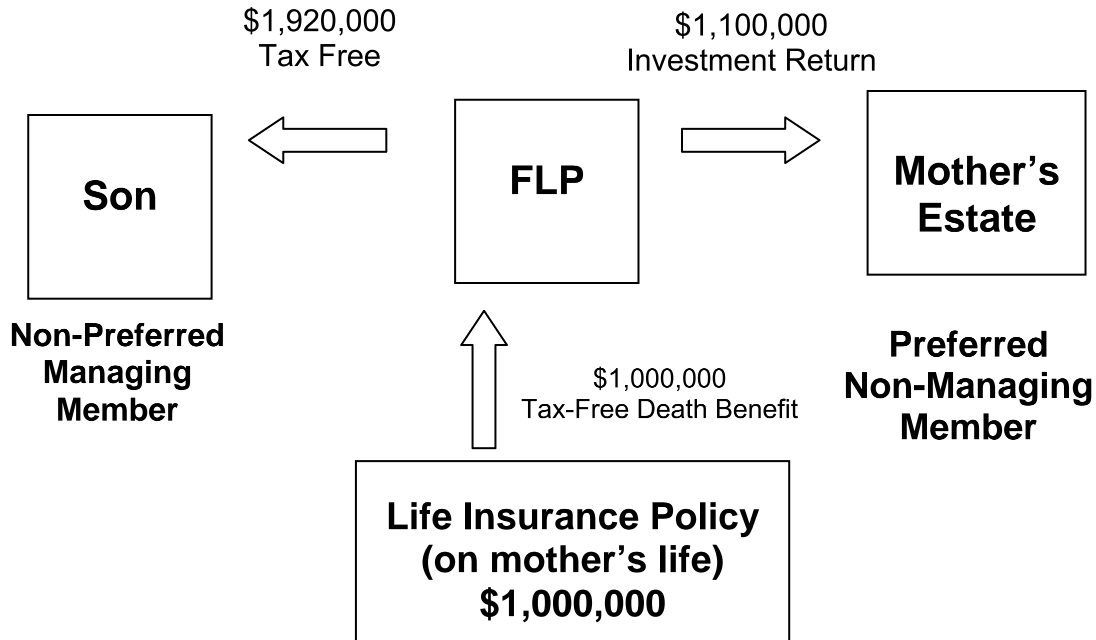


What happens after Mother dies one (1) year later?

1) The FLP would be dissolved

2) The mother's estate would receive as a preferred investor in the LLC the remaining $1,000,000 preferred interest plus a 10% rate of return ($1,100,000)

3) The son receives via the dissolution his initial $20,000 investment, $1,000,000 in assets via the gifted non-preferred interest from the mother, and the $900,000 death benefit which was paid income tax free to the FLP prior to dissolution. The son owes no estate taxes on these assets and no income taxes.



Multiplying the Discounts

The previous example is a great way to show a client how to freeze the value of a preferred interest in an FLP and how to use life insurance as a nice way to pass wealth income and estate tax free to the heirs without incurring gift or estate taxes.

The following is a much more interesting example that will illustrate how to use the same structure to dramatically increase the discounts available for estate tax purposes. We need to assume some additional facts.

1) Assume the client (mother) has **no need for a future flow of income**.

2) Assume the client has a $25,000,000 estate and has $10,000,000 in bank accounts, CDs, or securities. Further assume that much of the entire $25,000,000 is includable in the client's estate for estate tax purposes.

3) Assume the client is totally uninsurable and cannot purchase life insurance (which would be owned by an irrevocable life insurance trust) to pay for estate taxes.

4) Assume the son is 45 years old and in good health.

5) Finally, let's assume an additional goal is to create a situation where the heirs could have access to cash (tax free) at some point in the future before the mother dies rather than waiting.

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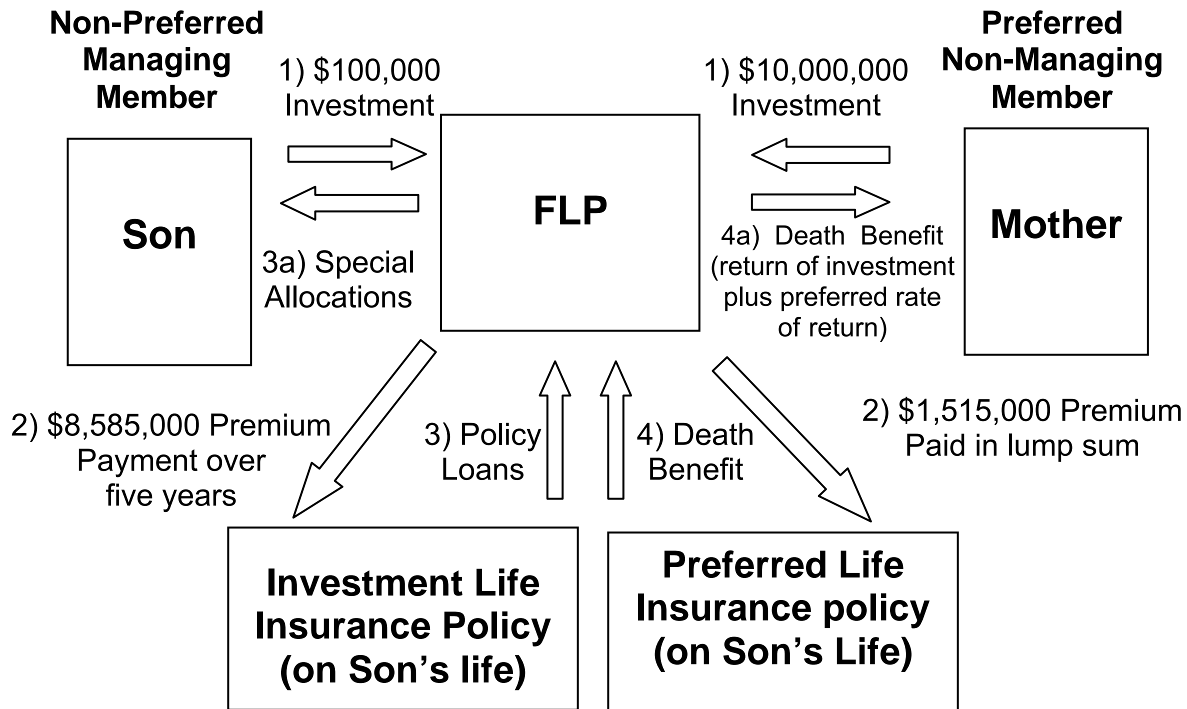

Steps for the above schematic

1) Mother and son both capitalize the FLP (no gift-tax issues). Mother is the preferred non-managing member, and the son is the non-preferred managing member (who controls the investments of the FLP). Because this is a related party transaction, mother's rate of return on her preferred interest can be limited to a reasonable rate of return (like the long-term Applicable Federal Rate (AFR) based on simple vs. compound interest). Let's assume the long-term AFR is 5%.

2) The FLP invests in two separate life insurance policies using the son's life. The "preferred" policy is strictly used to pay back mother her preferred investment plus a simple interest rate of return (therefore, the FLP will purchase an increasing death benefit policy).

With the remaining money, the FLP will purchase a "cash building" life insurance policy as an investment (in the example, an indexed equity life policy is used). The premium is paid into the policy over a seven-year period so the policy does not become a modified endowment contract (which would prevent tax-free loans from being taken from the policy).

3) When and if the son needs cash, he would have the FLP take a "policy loan" from the cash-building policy. There is no income tax due when an owner of a life policy takes a loan (assuming the policy stays in force until death).

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3a) The son then would take a "special allocation" from the FLP in an equal amount to the loan. The special allocation is an income-tax-free transaction due to the fact that the son will assume the debt of the FLP to the life insurance company.

A complete explanation of a special allocation and adjusting the member's capital accounts is outside the scope of this material. For more information, please contact The Wealth Preservation Institute.

4) When the son dies, a death benefit will pay from the preferred policy to the mother, if still living; and, if not, it will pass to the heirs.

Explaining the benefits of the previous transaction:

1) There are **no gift taxes with this transaction**. The mother was able to transfer $10,000,000 into an FLP and have $8,500,000 invested into a cash-building life insurance policy where the son will have access to the cash through special allocations both gift and income tax free.

Multiplying the discounts

2) While living, the mother owns a very interesting asset from an estate tax point of view. The mother now owns FLP units that will not pay unless and until the son dies. The son is 45 when the preferred life policy is purchased, and his life expectancy is age 82. If the 75-year-old mother dies next year or in five, ten, or twenty years, the question for evaluation purposes is **what is the current value of her interest in the FLP when she dies** (taking into consideration the son's life expectancy is 82)?

The following chart will illustrate the power of this technique for estate tax planning by illustrating different discounting percentages:

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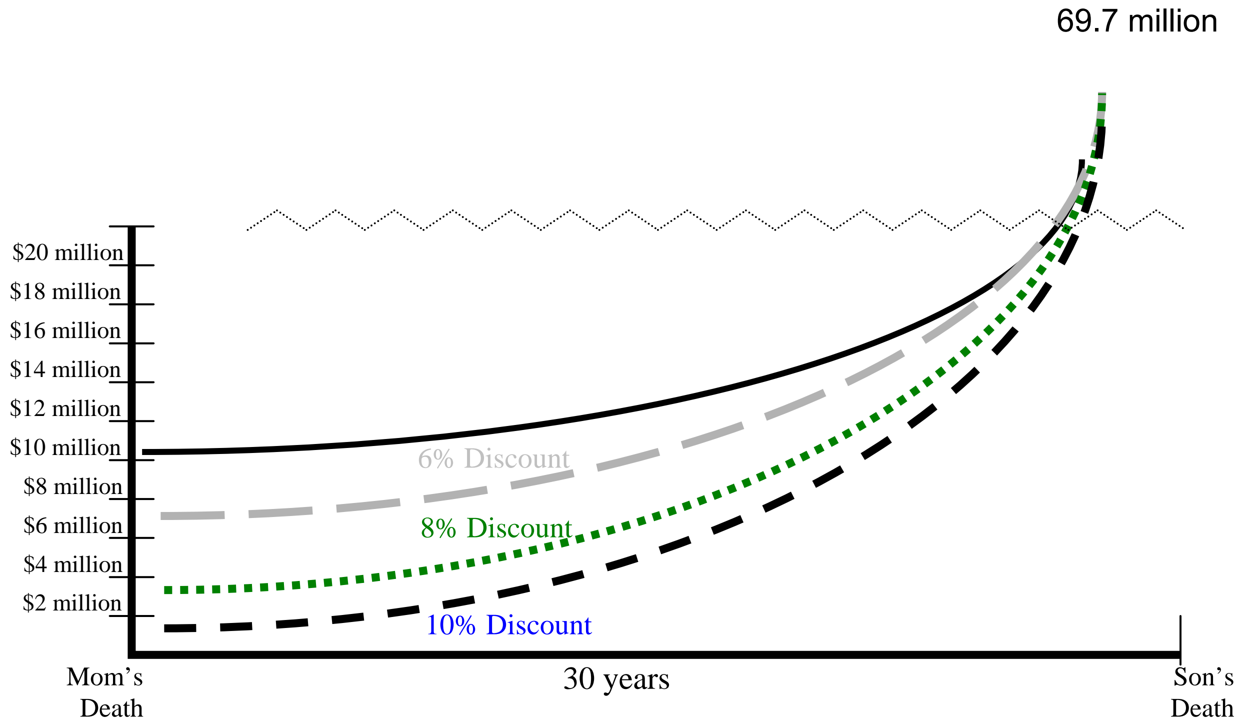

Projected value of ownership interest in mother's estate at the time of formation and purchase of the preferred life insurance policy:

At a 6% discount	$6,692,614
At an 8% discount	$2,510,710
At a 10% discount	$1,815,664
At a 12% discount	$ 925,210
At a 14% discount	$ 464,209

Most attorneys who understand this strategy are comfortable with at least a 10%-14% discount. Therefore, if mother died in year one, the value of the FLP interest in her estate would be $1,815,664 (using a 10% discount), NOT the $10,000,000 she capitalized the FLP with. Why? Because the FLP units are not liquid and will not pay off from the investment in the FLP until the son dies. The calculation is to find out the current value of a future interest; and, when discounted, the number becomes very low.

The reason typical **20-40% FLP discounts are not used** is due to the fact that the mother's interest is "preferred;" and, therefore, the value of her interest cannot be discounted to the same degree as FLP interests in a "traditional" FLP set up for estate planning purposes.

Even if mother dies in five, ten or twenty years, there is always a sizable discount in the value of the FLP interest due to the fact that the interest is always going to be discounted based her son's projected life expectancy.

Summary of the Preferred Non-manager/Non-preferred Manager LLC Structure

This structure is one of the most powerful and little known estate planning techniques in the estate planning industry. It is very flexible, depending on the needs of the clients, and cannot only significantly reduce the size of a taxable estate (without gift taxes) but can also create a situation where a young heir can have access to income and gift tax free loans from a life insurance policy years before a parent passes away.

While at first glance, the schematic is not the simplest to grasp. After going through the material a few times, most advisors will be comfortable enough with the techniques to discuss them with clients and other advisors.

Grantor Retained Annuity Trusts

A Grantor Retained Annuity Trust ("GRAT") is a sophisticated gift tax planning technique typically used by individuals who desire to gift assets that are expected to appreciate in value to their children while retaining an income stream from those assets in the form of an annuity for a period of years. A key attribute of a GRAT is the ability for a grantor to structure the trust to result in little to no gift taxes being due at the time the GRAT is established.

Overview

A key theme in sophisticated estate planning is utilizing techniques that provide a means for wealthy individuals to shift wealth from one generation to the next while minimizing estate and gift tax exposure. In so doing, a GRAT provides an individual with a vehicle through which he or she can gift assets that are expected to appreciate in value to children with minimal gift tax exposure. Thus, GRATs can present significant wealth transfer planning opportunities when utilized as part of a wealthy individual's or wealthy family's overall estate plan.

A GRAT is an **irrevocable trust** in which the **grantor retains an income interest** (usually in the form of an annuity) in the assets the grantor transfers to the trust. The retained annuity is usually for a term of years; and at the expiration of the GRAT's term, the assets remaining in the GRAT are either transferred outright to the beneficiaries of the GRAT or are held in trust for the beneficiaries' benefit.

The grantor of a GRAT can act as the trustee of the GRAT during its term. Upon termination of the GRAT, if the assets held by the GRAT are to be distributed to trusts for the benefit of the GRAT beneficiaries, then, to avoid adverse estate tax consequences, the grantor (or the grantor's spouse) should not be named as trustee of such trusts.

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For gift-tax purposes, the **value of the gift is based on the value of the remainder interest** in the GRAT (if any) **at the time the GRAT is created**. Because in a GRAT the grantor retains an interest in the property transferred for a term of years and thus delays the time at which the beneficiaries will receive any property from the GRAT, the value of the gift is typically a fraction of the total value of the property contributed to the GRAT upon creation. In fact, if the value of the annuity retained by the grantor is high enough and the term of years of the GRAT is long enough, it is possible to structure a GRAT to result in little or no gift tax upon creation (so-called "zeroed-out GRAT" or "Walton GRAT" (Walton v. Commissioner*, 115 T.C. 589 (200*0))).

Specifically, the value of the gift upon creation is based on three factors:

1) The term of the GRAT

2) The value of the annuity interest retained by the grantor, and

3) The current discount rate (the Code Section 7520 rate) in effect during the month in which the GRAT was created.

Why is this important? Because the value of the gift is based on the value of the assets on the date the assets are contributed to the GRAT. The **leverage of the GRAT lies in the ability of the assets contributed to appreciate in value** at a rate that exceeds a presumed rate of appreciation that the IRS requires to be factored into the gift (i.e., the discount rate mentioned above).

To the extent the assets appreciate in value at a rate in excess of the discount rate from the time of the GRAT's creation until its termination, all of such appreciation from the date of the GRAT's creation until its termination will pass to the beneficiaries of the GRAT gift tax free.

In a zeroed-out GRAT, the value of the annuity interest retained by the grantor is equal to the value of the property contributed to the GRAT resulting in net flexible gifts at the time of creation. Thus, if a grantor transfers $1,000,000 of assets to a GRAT but retains a $1,000,000 annuity interest for the term of the GRAT and the assets held by the GRAT appreciate to $1,500,000, the $500,000 worth of appreciation is transferred to the beneficiaries of the GRAT gift tax free. This is so because the value for gift tax purposes was determined on the date the GRAT was created, which, in the above example, would have been zero since the grantor retained a $1,000,000 annuity interest in the $1,000,000 worth of property contributed to the GRAT.

It should be noted, however, that, while the GRAT can present substantial gift-tax planning advantages, there is the risk that, **if the grantor dies during the GRAT's term**, **all of the assets** held by the GRAT at the time of the grantor's death (including the appreciation on the assets that has occurred after the creation of the GRAT) **will be included in the grantor's estate**.

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GRAT Structure

For a GRAT to qualify with the IRS, the **trust agreement must be irrevocable;** and the grantor must retain an interest in the GRAT stated as either a fixed dollar amount or a fixed percentage of the GRAT's initial value based on the value of the assets contributed to the GRAT on the date it is created. Once the GRAT is funded, the grantor may not add any more assets. The annuity amount **must be paid at least annually, whether or not the GRAT assets generate enough income**. If the assets contributed to the GRAT do not generate enough cash flow to satisfy the annuity payment each year, the GRAT will be required to distribute a portion of the principal by liquidating some of the GRAT's assets to satisfy the annual guaranty requirement. Promissory notes cannot be used to satisfy the annuity payments to the grantor.

Because the annuity interest of a GRAT must be fixed at the time the GRAT is created, careful attention should be paid to obtaining a very accurate valuation of the assets involved. This is especially so if contributions of income producing real estate, subchapter S corporation stock, limited partnership interests, or limited liability company interests, or other closely held business interests are being made to the GRAT. It is this author's opinion that an individual seeking to use a GRAT should obtain the best appraisal possible of the assets being contributed to mitigate any challenge in the future.

Maximizing Wealth Transfer Planning Through Zero Gift Tax GRATs

The IRS recently issued new regulations in response to a taxpayer victory in connection with GRAT planning. Essentially, the new regulations provide that a GRAT can be structured to result in a minimal (e.g., $.01) gift upon creation based on the factors discussed earlier (i.e., the zeroed-out GRAT). The significance of this ruling can best be explained by the following example:

Suppose an individual, age 50, has an asset that is expected to appreciate rapidly over the next three years but currently has a relatively low value (for example, pre-IPO stock). Suppose also that the individual wants to transfer some wealth to the children but is not happy about the prospects of paying gift taxes. A possible solution is the zeroed-out GRAT. If, for example, the asset is worth $1,000,000 but the individual thinks it will appreciate by 20% each year for the next three years, a zeroed-out GRAT, structured to have a three-year term and based on the current Code Section 7520 rate, would produce the following results:

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Value of property contributed:	$1,000,000
Value of the grantor's retained interest:	$999,999.86
Term:	3 years
Annual Annuity Payment:	$364,458
Value of gift on creation:	$.14
Value of assets at the end of the GRAT term that pass to beneficiaries **GIFT TAX FREE:**	$401,372

Finally, consider the overall impact of a GRAT when coupled with the use of an FLP to which discounts may be applied up front. In such a situation, while the underlying assets of the FLP may be valued at $1,000,000, the value of the interests (the asset being transferred to the GRAT) may be subject to a discount, which compresses the value of the assets as of the date of contribution. Thus, the value of the retained interest required to result in a zeroed-out GRAT will be less, which means that the combination of the GRAT terms, annuity amount, and discount rate, coupled with the discount applied to the property transferred to the GRAT, will result in even more being transferred to the beneficiaries of the GRAT gift tax free.

Other Tax and Administration Issues

Income Taxes

GRATs are considered grantor trusts, which mean that the grantor will be deemed the owner of the trust for income tax purposes. **All of the income of the trust is taxable to the grantor rather than the trust itself**. While paying taxes on behalf of the GRAT may not seem like a benefit to most clients, the payment of the trust's taxes by the grantor is an additional tax-free gift to the beneficiaries, which also reduces the value of the grantor's taxable estate.

Estate or Generation-Skipping Tax Planning Issues

The age of the grantor is an important factor in considering whether to use a GRAT. The older the grantor at the time the GRAT is created, the greater the risk that he or she will die during the term of the trust and result in the assets of the GRAT being included in the grantor's estate. If the grantor dies during the trust term, the impact is the same as if the GRAT had never been created; the value of the assets held by the GRAT would be included in the grantor's estate. There would be no penalty for establishing the GRAT.

If the grantor of the GRAT is married, careful attention should be given to ensuring that it is drafted correctly to provide that, if the grantor dies during the term of the GRAT, the assets will be transferred to the grantor's estate in a manner that qualifies for the unlimited marital deduction. If a GRAT is not

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drafted correctly and the grantor dies during the term of the trust, the loss of the tax advantage of the unlimited marital deduction can be tremendous and may result in the imposition of a tax that could otherwise have been avoided.

Another shortcoming of a GRAT is that it is not a good generation-skipping tax planning tool. This is because the beneficiaries of a GRAT do not receive their gifts until the trust term ends. This is when the grantor can allocate a generation-skipping tax exemption. The allocation is based on the actual amount of assets passing to the beneficiaries receiving the generation-skipping distribution at the end of the GRAT term. Because this amount is not known until the end of the GRAT term, the uncertainty of being unable to predict this amount limits the ability to engage in generation-skipping tax planning when the GRAT is created.

Sales to Intentionally Defective Grantor Trusts (IDGT)

A sale to an Intentionally Defective Grantor Trust ("IDGT") is a sophisticated estate planning strategy that can provide substantial benefits to wealthy individuals and families seeking to transfer assets from one generation to the next (and to future generations) while minimizing income, estate and gift tax liabilities.

This technique is **particularly effective in business-succession planning for families with closely held businesses structured as partnerships or subchapter S corporations** and is intended to accomplish the following goals:

1) Transferring assets to a trust for the benefit of an individual's (hereinafter referred to as the "grantor") children or future generations without incurring any gift or income taxes or capital gains taxes on the sale, and

2) Shifting the value of the assets sold in excess of the discounted value purchase price and any future appreciation on those assets out of the grantor's estate for estate tax purposes. The following summarizes the transaction in more detail:

Overview of the Intentionally Defective Grantor Trust

An IDGT is an irrevocable trust typically established as a perpetual trust (a so-called "Dynasty Trust") for the benefit of the grantor's children and future descendants. An IDGT generally benefits the grantor's children during their lifetimes and is structured to benefit the grantor's children's descendants and future generations after their death.

From an income and estate planning perspective, **the IDGT would be purposely structured to be "defective" for income tax purposes** but "effective" for estate tax purposes. Despite the fact that the IDGT would be a legal entity separate from the grantor, certain provisions in the IDGT agreement would provide the grantor with certain powers over the IDGT that cause it to be considered a "grantor trust" with respect to the grantor for income tax purposes but would **not** result in the assets of the trust being included in the grantor's estate for estate tax purposes.

Consequently, the grantor would be considered the owner of the IDGT for income tax purposes, which would result in the **grantor being taxable on the IDGT's income**. The grantor and the IDGT would not be considered separate taxpayers for income tax purposes but would be considered separate taxpayers for estate tax purposes. Because of the IDGT's status as a grantor trust for income tax purposes, an IDGT can hold subchapter S corporation stock without jeopardizing the corporation's subchapter S status, or having to make a qualified subchapter S trust, or electing small business trust election. When the IDGT later becomes a separate taxpayer from the grantor for income tax purposes, the IDGT would then make the election to be a qualified subchapter S trust or an electing small business trust.

The Powers that Create a "Defective" Grantor Trust

The following is a summary of the most common powers included in an IDGT that cause the trust to be classified as a "grantor" trust for income tax purposes but will not result in the assets of the trust being included in the grantor's estate:

(1) The Power to Reacquire Trust Property (IRC Section 675(4)(c))

In general, the power to **reacquire trust property** by substituting property of equivalent value, when exercised in a non-fiduciary capacity by any person, without the approval of any other person acting in a fiduciary capacity, should create grantor trust status but not result in the assets of the IDGT being included in the grantor's estate. The service has indicated that such a power does not constitute the power to revoke, amend, or alter the trust under IRC Section 2038 and; therefore, the trust's assets are not included in the grantor's estate (See, PLR 9548013).

The basis for this reasoning rests in the concept that, even if an individual acts in a non-fiduciary capacity to reacquire trust property and substitute property of equivalent value, the trustee of the IDGT is still bound by his or her fiduciary standards to ensure that the property substituted represents full and adequate consideration for the corpus reacquired. Therefore, under such logic, the grantor of the IDGT ought to be able to act, in a non-fiduciary capacity, to reacquire the trust corpus and replace such corpus with property of equivalent value. To this end, there is some commentary that suggests the grantor may retain the right, in a non-fiduciary capacity, to sell the IDGT's assets or change

the nature of the trust's assets, provided that the standards detailed above are adhered to.

(2) Power to Borrow Trust Assets **without** Adequate Interest or Security (IRC Section 675(2))

If a grantor may borrow the IDGT's assets for less than adequate interest and security or for terms that are more favorable than what would otherwise be required for such a transaction under general commercial terms, the trust will have grantor-trust status.

(3) The Power to Use the IDGT's Income for the Purpose of Paying Insurance Premiums (IRC Section 677(a)(3))

An IDGT may hold a broad array of **investments including life insurance on the life of the grantor**. In so doing, Section 677(a)(3) provides that a trust will be considered a grantor trust to the extent the income of the trust is applied for the benefit of the grantor, which includes the payment of insurance premiums on the grantor's life. Thus, in some planning transactions, such as where the cash flow required to service the IDGT debt to the grantor for the sale of the property to the trust is less than the total cash flow to the IDGT (i.e., there is a surplus of cash flow to the IDGT), the trustee can use any excess proceeds to purchase life insurance on the life of the grantor.

The benefit: so long as the policy is owned exclusively by the IDGT and the grantor does not retain any "incidents of ownership" with respect to the policy, the death benefit proceeds of life insurance will be paid to the IDGT **estate, gift and income tax free**.

Outright Gifts to an IDGT

While IDGTs are typically used in conjunction with a sale of assets to the trust (see below), a client can simply make an outright gift to an IDGT using the client's gift and estate tax exemptions. A client can gift assets to an IDGT (which is set up as an irrevocable trust), and the gift works like any gift to when using a client's gift and estate tax exemptions.

The unique aspect to an IDGT is that the gift is complete for estate tax purposes but incomplete when it comes to the income taxes (from income generated from the assets gifted to the IDGT). As discussed, income produced inside an IDGT inures to the donor (and the payment of that tax is **not considered a gift**). Also, when property is not sold to the IDGT, the three-year, look-back rule with any gift applies; and so it is important to disclose that to the client when considering an outright gift to an IDGT or a sale as discussed next.

Structuring the Sale

As mentioned above, the installment sale to an IDGT technique can provide substantial income, estate and wealth transfer planning benefits. Because such sales are used extensively for business succession planning, the examples used in this section will focus on the sale of subchapter S corporation stock to an IDGT. As a general premise, however, the sale structure would be similar to that of most types of entities, including interests in family limited partnerships or limited liability companies.

To ensure that the sale transaction to the IDGT is respected by the IRS, certain attributes of the transaction should be respected. First, the IDGT must have assets that provide economic substance prior to the sale. The general rule of thumb is that the IDGT should have assets worth at least 10% of the value of those that are being sold to it.

When considering an installment sale transaction in which a business owner is going to sell his or her subchapter S corporation shares to an IDGT, the IDGT must have assets worth at least 10% of the purchase price value of the stock. Therefore, in a typical sale transaction, the grantor will gift a certain amount of "seed money" to the IDGT so that it would have enough economic substance to support the installment sale and payments due under a promissory note from the IDGT to the grantor upon the trust's purchase of the stock.

When making this seed gift, it is typical for the grantor to use up a portion of the lifetime exemption to fund the IDGT. It is important to note that an individual can only gift up to $5,000,000 (at least from 2011-2012) during his or her lifetime without incurring any gift tax (the so-called "lifetime gift exemption").

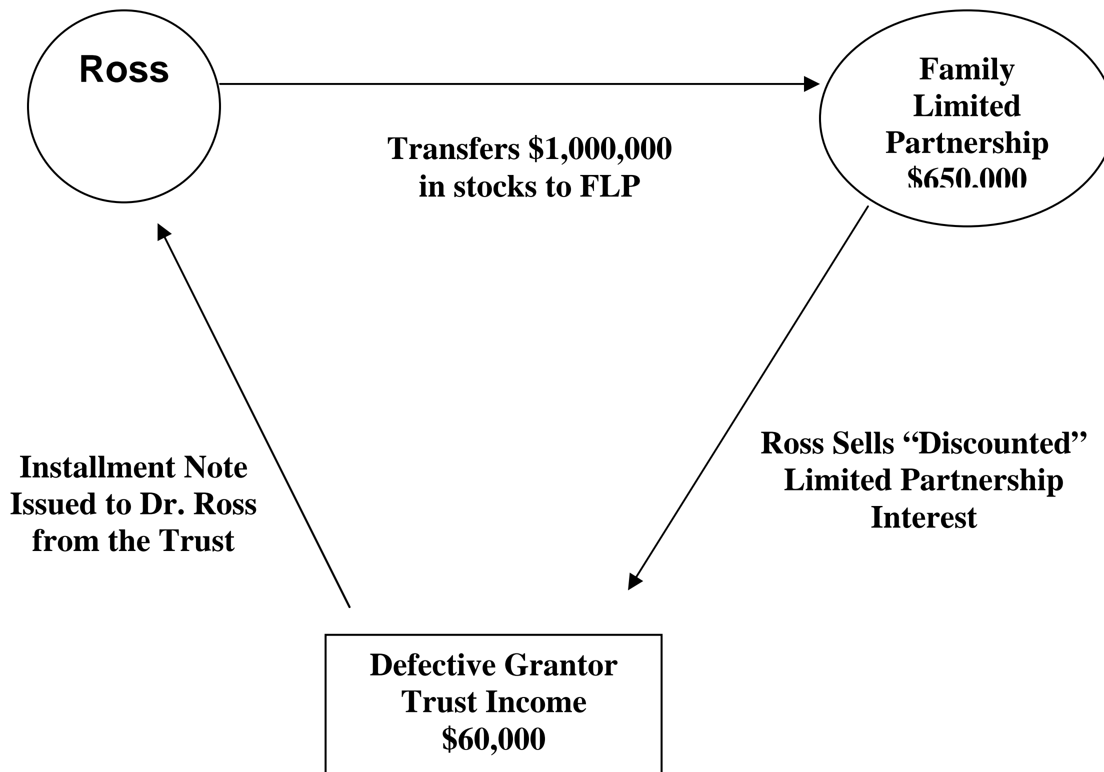
> ***Example:*** If the grantor were to gift $1,000,000 to the IDGT as the 10% seed money, the IDGT would have $1,000,000 in assets and could then purchase up to $10,000,000 worth of the grantor's stock. If the value of the stock was, in fact, $10,000,000 (which could possibly be a discounted price), the sale would move all of the stock to the IDGT for the grantor's children (who are the ultimate beneficiaries of the trust).
>
> **Planning Tip:** Consider structuring the sale to take advantage of valuation discounts which could be applied to different classes of stock. In a subchapter S corporation, if the corporation does not already have both voting and non-voting shares, consider recapitalizing the corporation to have both classes. For purposes of the sale, the shares to be sold would be the grantor's non-voting shares; and those shares will likely be subject to the greatest amount of discounts. The same concept should apply to selling limited partnership interests in an FLP to an IDGT (see below)

Discount Strategy (The Use of an FLP)

Let's combine a Family Limited Partnership with an IDGT. Clients looking to maximize the economic benefit (paying the least amount of gift or income taxes) of an IDGT should incorporate the use of an FLP. The best way to explain the discounting strategy with an FLP and an IDGT is with an example.

Assume your client, Dr. Ross, transfers a mixed portfolio of investments (stocks, bonds, and cash) worth $1 million to an FLP. Typical FLP discounts reduce the value of that $1 million to about $650,000. Then Ross creates an IDGT and sells the $650,000 of the limited partnership interests to the IDGT in exchange for a note. If the portfolio produces a return of 6% or $60,000, the same income measured against the depreciated value results in a return of 9.2% ($60,000 ÷ $650,000).

If the client sells the FLP interest to the IDGT in exchange for future payments, those future payments will be based on the lower value of the FLP interest (vs. the actual value of the assets in the FLP), thereby, reducing the size of the required installment note payments to the grantor. If the client chose to gift the FLP interest to the IDGT instead of selling the interest, the obvious benefit to incorporating an FLP and an IDGT is the fact that the client only uses $650,000of his gift tax exemption.



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Once the number of shares to be sold is determined (which will be a function of the value of the shares to be sold), the grantor would then sell his or her nonvoting stock to the IDGT for a price determined by an independent appraiser, taking into account all appropriate discounts. It is critically important that appraisals used be of the highest quality and strength; otherwise gift tax may be incurred.

As noted above, because the IDGT is not considered a separate taxpayer from the grantor, there is **no recognition of capital gains** on the sale. Also, since the IDGT would be purchasing the stock from the grantor at a market value determined by a qualified appraiser, there would be **no gift** being made **and no gift taxes** due on the sale.

The IDGT would **issue the grantor an installment note** and give the grantor a security interest in the stock. The note would bear interest at the IRS assumed rate (the "federal applicable rate") and could be structured as a self-amortizing note, a level principal payment note, or an interest-only with balloon payment note. The type of note used will largely depend on the cash flow being generated by the assets being sold to the IDGT. Because the grantor and the IDGT are not considered separate taxpayers for income tax purposes**, the grantor will not recognize income when the interest on the notes is received**.

Benefits of the Transaction

Under the terms of the installment sale transaction, the grantor would receive, through the installment payments, the discounted purchase price of the stock, plus interest at the applicable federal rate. Although these payments to the grantor are disregarded for income tax purposes, the grantor will, however, pay the taxes on the earnings attributed to the shares owned by the IDGT in the S corporation each year. **If planned correctly, the grantor will be able to pay the income taxes on the IDGT assets out of the installment sale payments being made each year under the terms of the installment note.** The IDGT would receive distributions on the non-voting shares each year from the subchapter S corporation, which, in turn, would be used to make the installment payments to the grantor.

> **Observation:** In the normal course of the transaction, the IDGT would remain "defective" for the entire term of the sale, which preserves the non-recognition of capital gains and interest income during the term of the note. Although, technically, the provisions of the IDGT would provide the grantor with a right to terminate the IDGT's "defective" trust status at any time. It is important to understand that, if the grantor exercises this right during the term of the sale, it would have significant adverse tax consequences to the grantor (i.e., recognition of capital gains and ordinary income on the payments made to grantor by the IDGT). Thus, most individuals contemplating this transaction anticipate that the IDGT will remain

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"defective" at least for the time period of the note and will not end until after the transaction has been completed.

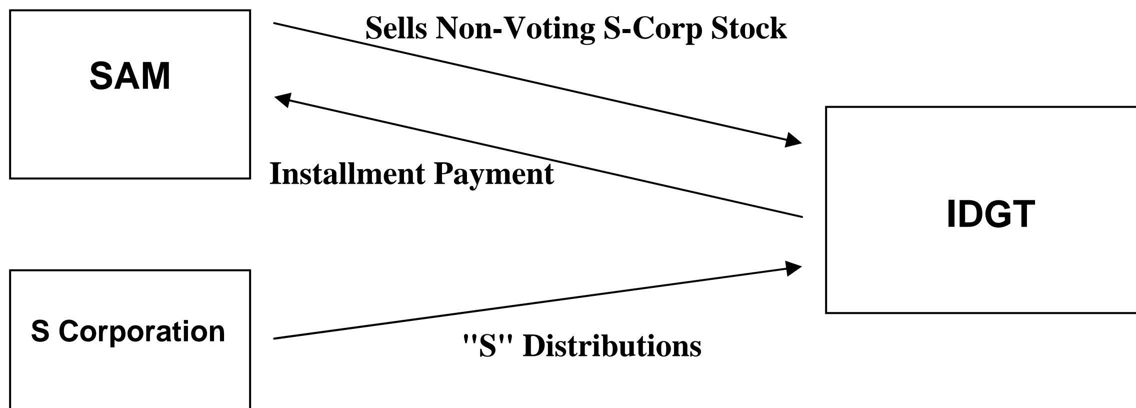
It should also be noted that, if the grantor dies during the term of the sale, **the balance** (if any) of the installment note that has not been paid off at the time of his or her death **will be included in the grantor's estate**. The actual assets held by the IDGT at the time of the grantor's death (i.e., the subchapter S corporation stock) and any appreciation that has occurred from the date of the sale **will not be included in the grantor's estate**. This is a significant advantage in comparison to a Grantor Retained Annuity Trust. To mitigate the inclusion of all or a portion of the installment note being included in the grantor's estate, however, the grantor might consider using a "Self-Canceling Installment Note" ("SCIN") or a "Private Annuity" in lieu of a traditional installment note to finance the sale.

It is important to note that, because the grantor is paying the income taxes on the IDGT assets and relieving it of that obligation, the grantor is, in essence, making transfers of tax-free gifts to the children and future generations equal to the income taxes paid on behalf of the IDGT. The end result is that the grantor will shift to the children (and future descendants) free of gift or estate tax (1) the value of the stock in excess of the discounted purchase price and any future appreciation on that stock, and (2) the value of the payments of the income taxes made by the grantor that would otherwise have been paid by the IDGT, resulting in a reduction of the assets that ultimately pass to the children and future descendants.

More Examples

Example of an Outright Gift of Property or Assets to an IDGT:

Client (Sam) transfers $1 million worth of income producing property to an IDGT for the benefit of his children. This is an outright gift covered by Sam's $1,000,000?? gift tax exemption, so no gift tax is due.



Summary of Transaction:

The sale of the non-voting stock from Sam to the IDGT essentially "freezes" the value of the non-voting stock at its value at the time the sale. The trust can provide for Matt, who is the beneficiary of the trust (via whatever language Sam inserted when creating the trust). Following Sam's death, the trust could distribute the shares to Matt or continue to hold them in trust.

Since Sam has retained all of the voting stock, he continues to control the business. No portion of the trust will be included in Sam's estate (for estate tax calculations) due to the fact that Sam sold the non-voting stock to the IDGT in exchange for an installment note/payment. The trust assets would also be excluded from Sam's estate if he used his unified credit to gift the non-voting stock to the IDGT

The trust will get funds to pay Sam the interest on the note, plus principal, from dividend distributions from the stock. Distributions from the S-Corporation are at Sam's discretion due to the fact that he retained the voting stock. Because the IDGT is ignored for income tax purposes, Sam will not be taxed on the interest he receives from the trust but will be taxed on the dividends received by the trust. In essence, Sam is taxed on the income from the S-Corporation just as if he had not created the IDGT.

Selling the Business

Eventually, when Sam sells his business, he removes all future appreciation from his estate for estate tax purposes. For example: Assume Sam's business was worth $1,000,000 when he gifted all of his non-voting interest in the company to the IDGT. Then, assume that, when Sam sold the business 10 years later, he got $2,000,000. All of the appreciation of the non-voting interest in the company in the IDGT effectively passed to the heirs without paying any additional estate taxes.

Typically, when an installment note is used with an IDGT in conjunction with non-voting interest of a company where there is an income stream to the grantor via an installment note, the interest on the note is less than the amount of the dividend. This creates a situation where the assets in the trust continue to grow and will pass estate tax free to the beneficiaries.

When Sam gifts the S-Corporation stock to the IDGT, he has to pay income tax on all dividends paid from the company to the IDGT. Normally, when a parent gifts something to a child (and, essentially, Sam was gifting the income taxes he was paying on the dividends paid to the IDGT), gift taxes are due. By gifting the S-Corporation stock to the IDGT, Sam's payment of income tax is not considered a gift, thereby significantly increasing the value of the IDGT from an estate planning perspective.

Finally, using the IDGT, Sam did not have to give up control of his interest in the business due to the fact that he retained the voting interest in the business until Sam decided to sell the business to an outside buyer.

Leveraging Assets (the use of life insurance)

The IDGT provides an excellent way to acquire significant amounts of life insurance without having to worry about taxable gifts on the premium payments. Most wealthy clients who have put off doing proper estate planning end up having their advisors tell them that they must set up an Irrevocable Life Insurance Trust (ILIT) so the death benefit can pay for the inevitable estate taxes that will be due. While it is easy for an advisor to tell a high net worth client to gift $150,000 in premium to an ILIT, most clients are upset when they hear that they must pay gift tax on some of the premium gifted to the ILIT.

This makes the IDGT an easy sale, since the ability to discount the value of the property sold to the IDGT, combined with an interest-only installment payment, should provide the IDGT with sufficient **tax-free** cash flow to allow the funding for significant amounts of life insurance. The life insurance proceeds (from the newly purchased life policy which is owned by the IDGT) can be used to repay the note upon the grantor's death which effectively discounts the cost of repaying the note. Again, an example is the best way to illustrate this concept.

Example:

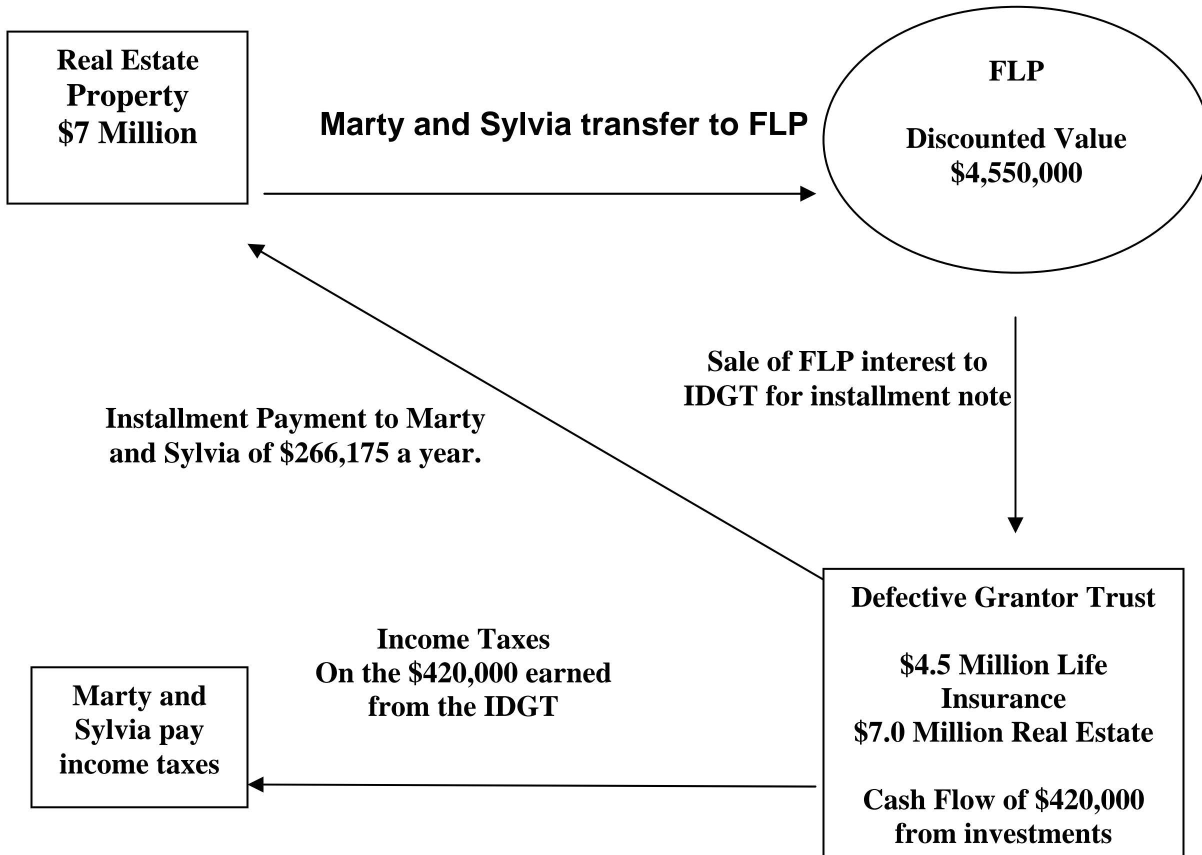
Marty and Sylvia, ages 68 and 67, have an estate valued at $18 million and would like to acquire a $4.5 million second-to-die survivorship life insurance policy for the benefit of their only child, Matt. Due to medical issues, however, the premium for the policy will be $150,000 per year. While there is plenty of cash flow available to pay the premium, Marty and Sylvia are concerned over the gift taxes that would be imposed on the premium payments if they were to gift $150,000 a year to an ILIT.

Among the assets owned by Marty and Sylvia are real estate investments valued at $7 million, generating income of 6% or $420,000 per year. Marty and Sylvia contribute their real estate interests to a newly formed FLP and receive a 1% general partnership interest and 99% limited partnership interests. Working with an appraiser, a 35% valuation discount was applied to the partnership interest.

Marty and Sylvia create an IDGT and **sell** their limited partnership interest to the trust in exchange for an interest-only note.

Gross Value of Property	$7,000,000
Discounted Value	$4,550,000
Term of Payment	interest only 15 years
Income on Property	6%
Property Growth	02%

Marty & Sylvia



Let's see how this arrangement can help fund the life insurance premiums without imposing gift taxes

Year	Installment Note	Trust Income	Interest on Note	Life Insurance Premiums	Excess Cash flow	Value of Property
1	$4,550,000	$420,000	$266,175	$150,000	$3,825	$7,140,000
5	4,550,000	454,621	266,175	150,000	38,446	7,728,566
10	4,550,000	501,939	266,175	150,000	85,764	8,532,961
15	4,550,000	554,181	266,175	150,000	138,006	9,421,078

This planning has allowed $4,871,078 (which is derived by subtracting the installment note from the property value in year 15) in value to be shifted to Matt free of all taxes while creating a death benefit of $4.5 million that will also be received totally tax free. It has also allowed Marty and Sylvia to make substantial tax-free gifts to the trust in the form of income taxes paid on the trust income.

The $266,175 of interest paid to them annually for 15 years is not taxable, but the $420,000 of income created inside the IDGT is taxable annually to Marty and Sylvia as grantors. Taxes on $420,000 at the 40% rate are $168,000; and,

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typically, a portion of the installment note payment of $266,175 is used to pay that tax.

If the grantor is still alive in 15 years when the note becomes due, there are a few options. The note could be re-done, or it could pay the $4.5 million due. Upon redoing the note, it could also be structured to start to pay down principal.

Planning Risks

The technique of a sale to a “defective” IDGT is not based on any one specific section of the Code but rather on several IRS private letter and revenue rulings that rely on the technical underpinnings of several sections of the Code and established tax principles. At this point, there is no concerted effort by the IRS to challenge this strategy; but it should be noted that the IRS has challenged certain aspects of the transaction without much success.

It is possible, therefore, that at some point in the future the IRS may try to attack the IDGT merely because it presents a tremendous opportunity for the taxpayer to shift value without a transfer tax. If the IRS were to challenge the technique, it would likely begin with the bona fides of the overall transaction (i.e., is the 10% seed money enough to justify a “commercially viable” sale, or should the non-recognition treatment afforded to the capital gains be recognized on the outstanding balance on the note if the grantor dies before the note is paid off). Any individual seeking to use this transaction should also consider that, by doing so, they would forego the step-up in basis the stock would normally receive if the individual held the stock at death.

Summary on IDGT

IDGT is not the simplest topic in the estate planning world, but it is one that can be a tremendous benefit to clients with a high net worth and a significant estate and gift tax problem.

If you are looking to offer some of your current clients an unusual benefit strategy or are looking to cultivate new high net worth clients, learning about and dealing with IDGT can help you reach those goals.

Self-Canceling Installment Note Transactions

A Self-Canceling Installment Note (“SCIN”) is a sales transaction that is payable in installments over a term of years that does **not exceed the seller’s life expectancy**. At the death of the seller, the buyer’s remaining obligations under the SCIN terminate (i.e., the obligations are “cancelled”) and **nothing is included in the seller’s estate for estate tax purposes**. Generally, SCINs are used when a senior family member desires to sell property to another family member with minimal gift and estate tax consequences but also desires to

maintain some amount of cash flow for a period of years.

For the SCIN to be respected by the IRS, the SCIN must have a properly designed "cancellation-on-death" provision. The impact of the cancellation-on-death feature is that **the buyer must pay a "risk premium"** under the terms of the SCIN, either:

1) In the form of an increased amount of interest (a so-called "interest-premium SCIN"), or

2) An increase in the principal payments to the seller (a so-called "principal premium SCIN"), or some combination of both to reflect the market value of the cancellation-on-death feature of the SCIN.

Because of the "risk premium," the SCIN must have an elevated interest rate for the life of the SCIN, or the payments (usually monthly or quarterly) from the IDGT to the seller would have to be increased above the normal amount calculated. Either way, or with a combination of the two, the IDGT will have to pay out more income annually with a SCIN transaction than with a fixed installment note for a period of years.

The risk premium is calculated by discounting the value of the note (applying the appropriate discount rate) and determining the seller's life expectancy from the appropriate mortality tables prescribed in the Treasury Regulations.

It is important to note that a SCIN will avoid gift and estate taxes as long as the self-cancellation feature is properly designed and the risk premium adequately reflects an arm's-length negotiation between the buyer and the seller. The consequence of inaccurately reflecting the value of the SCIN's cancellation feature is that the seller may be deemed to have made a part-sale/part-gift to the buyer. To the extent that the buyer retains any interest in the SCIN (i.e., the canceled payments due to the seller's death), the retained interest would be considered a gift; and the value of the property sold, less the consideration actually paid, will be included in the decedent's gross estate.

The IRS characterizes SCINs one of two ways for tax purposes. If the SCIN is structured to last for fewer years than the seller's life expectancy and the seller can qualify for installment sale reporting under Section 453 of the Code, the SCIN will be taxed in accordance with the rules governing installment sales (a so-called "installment SCIN"). If, however, the term of the SCIN equals or exceeds the seller's life expectancy, the SCIN will be taxed in accordance with the rules governing private annuities (a so-called "annuity SCIN").

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Income and Estate Tax Consequences of SCIN Transactions

SCINs can be used effectively in a variety of situations, such as sales to IDGTs (previously discussed), in which the tax treatment is largely the same or sales to non-grantor trusts or other family entities. Depending on the structure of the SCIN and the parties involved, the tax consequences of a SCIN transaction will differ dramatically due to the fact that the buyer is not an entity that is considered a "grantor trust" to the seller; and, thus, the **seller must recognize capital gains and interest income on each payment made from the note**.

From an estate and gift tax perspective, so long as the buyer purchases the assets or stock from the seller under a properly structured SCIN (one with the appropriate amount of premium added to the SCIN's principal amount or stated rate of interest), **there should be no gift taxes at the time of the sale;** and, if the seller were to die during the term of the SCIN, **nothing would be included in seller's estate for estate tax purposes** due to the SCIN's cancellation-on-death clause.

Additional Considerations

Although SCIN transactions can produce substantial wealth transfer planning benefits, there are other considerations to keep in mind when structuring the sale. One such consideration is that, because a "premium" is calculated into the value of the SCIN either as an increase in the principal amount of the note or an increase in the rate of interest that must be charged, if the SCIN is structured as either an installment SCIN or annuity SCIN and the seller lives to life expectancy or beyond, the buyer will be paying more to seller for the stock than the buyer would otherwise have been obligated to pay had the sale been structured as a traditional installment sale. **Additionally, because of the premium built into the terms of the note, the overall cost is higher, which increases the burden on the buyer's cash flow to make the annual payments**.

Finally, if the buyer is not an IDGT, then consideration needs to be given as to whether the note should be structured as an interest-premium note or a principal-premium note. The latter will typically give the buyer a higher cost basis, which, if depreciation deductions or other tax planning opportunities are contemplated by the buyer as part of the transaction, may require the SCIN to be structured under that format.

Private Annuity

Another variation on the SCIN is the "Private Annuity." Like the SCIN, payments from a private annuity end when the seller dies. **Unlike the SCIN, payments must be made for the life of the seller regardless of how many years the seller lives**. Caution, this will not work if the seller is terminally ill as

the seller will generally need to live at least 18 months after sale.

Caution: Private Annuity Trusts (PATs) used to be all the rage when an appreciated asset could be transferred to a trust in exchange for an annuity stream where the trust could sell the asset without a current capital gains tax being due. The capital gains tax would be amortized and a portion would be due each year over the life of the annuity payment. Because of the abuses of PATs, Congress acted to do away with the capital gains tax deferral.

Examples

Let's see how the installment sale for Marty and Sylvia from the earlier example would compare to a SCIN and a Private Annuity.

Private Annuity

With a private annuity, the required annual payment would be **$348,208**. These payments would have to be made for the life of the client. Within 14 years, the payments will exceed the initial value of FLP interests sold to the IDGT (which was value discounted to $4,550,000).

Remember from earlier that the regular installment, **non-SCIN** payments were $266,175 for 15 years with the balloon payment of $4,550,000 due at the end of the 15th year.

If it is likely the client will die before year 14 of the SCIN payments or the annuity payments, then the private annuity would be preferred because all payments would cease and there would be no income or estate tax issues to deal with. If a client who sets up a private annuity continues to live for many years past the assumed date of death, the structure will not have accomplished its goals due to the fact that through annuity payments most of the money ended up back in the client's estate via the high annuity payments.

SCIN

Using our same example, under a SCIN, either the principal value of $4,550,000 must be increased by $1,613,680 or the interest rate must be increased by 5.65% (This calculation comes directly from IRS statutes).

With our example, if the client chooses to increase the **value of the asset** when using a SCIN, the annual principal payment would be $394,245. With a situation where the client chooses to **increase the interest rate** on the installment note with a SCIN, the annual principal payment would be $286,667. Interest payments would vary as the principal is repaid on the loan. The interest-only note in a non-SCIN situation requires annual payments of $266,175 plus the balloon payment of $4,550,000 at the end of the 15th year.

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Again, the reason for the increased value or interest rate is due to the fact that the chance the grantor might die before the note pays is real. Therefore, if the client died prior to the end of the payment of SCIN at the payments calculated for a non-SCIN note (which would be much less), there is a significant chance of a windfall for the beneficiaries.

Summary on "Advanced" Estate Planning

Many advisors think they deal with "advanced" estate planning when in reality what they are providing for their clients is just average run-of-the-mill advice that any half-educated advisor can provide. The typical advice will suffice for many (and maybe most) clients who have sizable estates of less than $5,000,000, but what kind of advice should be given to clients with estates in excess of $5,000,000? And who is going to give that advice?

The material in this advanced education module should illustrate that there are a number of sophisticated planning techniques that are not widely known which can be very beneficial to high net worth clients. Advisors who can learn the material in this education module will be heads and shoulders above 99% of the other advisors in a local area. It matters not that you are in a metro area with some of the largest law firms or CPA firms in the country. Many do not know the strategies discussed in this section.

For financial planners, it is also interesting to note that the material in this education module is fairly life-insurance friendly due to the fact that it is such a vital estate planning tool for high net worth clients. It is the hope of The Wealth Preservation Institute that this chapter can propel advisors to another level of consulting and will help take the fear out of soliciting high net worth clients for their financial and estate planning work.

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