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# ESTATE PLANNING: WHAT NEXT?

**Fort Worth Chapter**
**Texas Society of Certified Public Accountants**
**Tax Institute**
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***by Marvin E. Blum***



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BIOGRAPHICAL INFORMATION

MARVIN BLUM, founding partner of THE BLUM FIRM, P.C. with law offices in Fort Worth and Dallas, specializes in the areas of estate planning and probate, asset protection planning, planning for closely-held businesses, tax planning, tax controversy, and charitable planning.

Blum, an attorney and certified public accountant, is Board Certified in Estate Planning and Probate Law and is a Fellow of the American College of Trust and Estate Counsel. He received his undergraduate degree in accounting at The University of Texas at Austin where he graduated first in his class and was named Ernst & Ernst Outstanding Student in Accounting. Blum received his law degree from The University of Texas School of Law where he graduated second in his class and was named the Prentice-Hall Outstanding Student in Taxation.

Blum is a frequent speaker and author on estate planning and tax topics. Since 2003, he has been included on *Texas Monthly's* annual list of *Texas Super Lawyers*, a list consisting of only five percent of all attorneys in the state. Additionally, Blum has been included in *Texas Monthly's "Top 100 Super Lawyers*" for the State of Texas. Recently, Blum received national recognition by New York's *Worth* magazine by being named to its prestigious *"Nation's Top 100 Attorneys"* list, comprising nominations from throughout the United States.

Blum is active in the Fort Worth community, serving in his 31st year as Treasurer of the Fort Worth Symphony. He is a lifetime trustee of Trinity Valley School where he served five years as President of the Board. Blum also served as chairman of The Multicultural Alliance, an organization devoted to fighting bias, bigotry, and racism. He and his wife, Laurie, are the parents of Adam, also a CPA and employed by Austin Ventures in Austin, Texas, and Elizabeth, currently residing in Philadelphia working on her Masters Degree at the University of Pennsylvania.

**ESTATE PLANNING: WHAT'S NEXT?**

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# ESTATE PLANNING: WHAT NEXT?

Presented by Marvin E. Blum
Prepared by Marvin E. Blum & Amanda L. Holliday

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to heaven, we were all going direct the other way – in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only." Charles Dickens, *A Tale of Two Cities*.[1]

Although Charles Dickens wrote these words over 150 years ago, they aptly describe the status of the estate tax laws today. When the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") was passed in 2001, which provided that the estate tax would be repealed for one year beginning January 1, 2010, most practitioners believed that the Internal Revenue Code would be amended long before the estate tax repeal occurred. However, we are over halfway through 2010 with no revision to the estate tax laws and no resolution in sight. As a result, under current law, individuals dying this year will pay no estate tax, but individuals dying in 2011 and later with assets over $1 million will pay estate tax at a top rate of 55%. This situation is creating vast inequities between estates of decedents dying in 2010 and all other estates.

As a prime example of the unusual effect that EGTRRA has had, consider the story of Dan L. Duncan. Duncan was a Texas pipeline tycoon who died in late March from a brain hemorrhage at the age of 77. Forbes Magazine estimated Duncan's net worth at about $9 billion, ranking him the 74th wealthiest person in the world. His holdings included boats, jewelry, automobiles, shotguns, a 5,500-acre wild game hunting ranch, and interests in EPCO and Dan Duncan L.L.P. If Duncan had died in 2009, his estate would have owed approximately $4 billion in tax, and if he had died in 2011, his estate would have owed almost $5 billion in tax (based on a $9 billion taxable estate). However, since Duncan's death occurred in 2010, his estate will pay no estate tax.[2]

George Steinbrenner is another billionaire whose heirs will benefit from the one-year repeal. Steinbrenner, long-time owner of the New York Yankees, died at the age of 80 from a heart attack on July 13. Forbes Magazine estimated his wealth at $1.1 billion, which included his ownership in the Yankees (and its related investments), various homes, and a stud farm in Ocala, Florida. By

dying in 2010, Steinbrenner's estate avoided between $495 million and $605 million in estate taxes. If all of Steinbrenner's assets were sold, the income tax bill could be as high as $165 million, which represents tax savings of about $330 million.[3]

As illustrated above, one way to avoid estate taxes is to die in 2010. If that doesn't appeal to you or your clients, however, the focus must be on planning now to reduce or eliminate estate taxes at death. Dealing with the ever-changing landscape regarding planning for estate taxes has become treacherous for individuals and their advisors. It is more important than ever to be aware of the latest developments affecting estate planning, as well as the best techniques to help clients avoid estate taxes to the maximum extent possible. Below we have discussed the status of estate tax legislation, as well as various techniques to help clients plan in the midst of this uncertainty.

## I. 2010 COMPLIANCE: STATUS OF ESTATE TAX LEGISLATION

It is impossible to predict with certainty what actions Congress will take with regard to the estate tax during 2010, and even beyond. As of July 16, 2010, only one estate tax bill has been introduced in 2010. On June 24, 2010, Senator Bernard Sanders (I-VT) introduced the "Responsible Estate Tax Act," with the support of Senators Tom Harkin (D-IA) and Sheldon Whitehouse (D-RI).

The proposed legislation calls for a $3.5 million estate tax exemption amount per person ($7 million for couples). According to Senator Sanders, this would exempt 99.75% of all estates from the federal estate tax in 2011. The tax rate applicable to estates with a value between $3.5 million and $10 million would be 45%. The tax rate applicable to estates with a value between $10 million and $50 million would be 50%. The tax rate applicable to estates with a value greater than $50 million would be 55%. With regard to any estate with a value above $500 million, the proposed legislation would impose a 10% surtax on the portion of the estate that exceeds $500 million.

In addition, the proposed legislation would attempt to close estate and gift tax "loopholes" by requiring consistent valuations for transfer tax and income tax purposes, modifying rules applying to valuation discounts, and requiring a 10-year minimum term for GRATs. The legislation would also liberalize the Special Use Valuation rule with regard to farmland and the estate tax rules related to conservation easements.

Commentators have indicated that, if passed, the legislation would be retroactively effective as of January 1, 2010. As discussed above, very wealthy people have already died in 2010, whose heirs have the wherewithal to challenge any such retroactive legislation on constitutional grounds. It is unknown whether such a challenge would be successful, and it would be many years before a final resolution was reached if the law was challenged.

At this time, it is unknown how much support this bill has in Congress and whether it will garner enough votes will pass. It is also possible that other legislation may be introduced later in the year, and it remains to be seen what form such legislation will take.

## A. SUMMARY OF ESTATE AND GIFT TAX LAWS DURING 2010

Under current law, for estates of decedents dying in 2010, a modified carryover basis rule will apply instead of an estate tax. Under Section 1022(a), the basis of property received from a decedent will be equal to the lesser of (i) the decedent's adjusted basis in the property, and (ii) the property's fair market value on the decedent's date of death.

Section 1022(b) allows the basis of the property to be increased by up to $1.3 million for property passing to someone other than the decedent's surviving spouse or a QTIP trust (i.e., a bypass or credit shelter trust). The basis of property passing to the surviving spouse or to a QTIP trust can be increased by up to $3 million. The surviving spouse's one-half interest in community property also qualifies to receive part of the $3 million basis allocation. In addition, capital loss carryovers and net operating loss carryovers that, but for the decedent's death, would have been carried forward to a later taxable year of the decedent and any losses that would have been allowable if the decedent had sold the property immediately before his or her death may be added to the property's basis.

For example, assume an individual dies owning a batch of assets worth $5 million that have a basis of $2 million. The individual's will leaves all of the assets to a QTIP trust for the surviving spouse. In that case, the assets will have a new basis of $5 million as of the individual's date of death.

Although no estate tax is applicable during 2010, the gift tax rules continue to apply to transfers made in 2010. The lifetime gift tax exemption continues to be $1 million per person, but the gift tax rate for taxable gifts made during 2010 has decreased to 35%. The gift tax rules applicable during 2010 will be discussed in more detail later in this outline.

## B. REVIEWING AND DRAFTING ESTATE PLANNING DOCUMENTS IN 2010

While waiting for Congress to act, we have been working with our clients to ensure that their documents are in compliance with 2010 laws in the event that a client dies in 2010. We have identified several situations in which a client's estate planning documents may require revising to ensure that the documents do not have unintended consequences if a client passes away in 2010. Some examples of these situations are as follows:

- For married couples, a formula bequest where some of the assets pass to the surviving spouse and the remaining assets pass to others, such as the children. For example, a will may use formulas to define a certain amount of assets that will pass to a bypass trust for the children (i.e., an amount equal to the individual's estate tax exemption) and provide that the remaining assets will pass to the QTIP trust. When applying the 2010 laws to the formula to calculate the amount passing to the bypass trust, the formula may be interpreted in such a way that all of the assets pass to the bypass trust or all of the assets pass to the QTIP trust.

- A formula bequest where some of the assets pass to grandchildren and other assets pass to children. For example, the will might leave all of the individual's GST exempt assets to the grandchildren and the remaining assets to the children. Since there is no GST exemption in 2010, it is possible that no assets would pass to the grandchildren if the individual died in 2010.

- Bequests that are defined by references to the estate tax exemption or GST exemption amount. For example, a bequest that leaves an amount of assets equal to the estate tax exemption in effect at the individual's death to children and the remaining assets to charity. Since no estate tax exemption is applicable during 2010, the bequest could arguably be read to leave all of the assets to charity, and none to the individual's children.

- Bequests that require the assets to qualify for a charitable contribution deduction or a marital deduction for estate tax purposes in order for the gift to be made. For example, a plan may make a bequest to charity but only allow it to be funded with assets that qualify for an estate tax charitable contribution deduction. There is no concept of a charitable contribution deduction under 2010 laws, in which case the gift to the charity would arguably be zero.

The impact of 2010 laws on an estate plan depends on the way the particular document is drafted. All documents are not the same, so it is important to read the documents carefully and determine the impact of the 2010 laws on a case-by-case basis. Amendments can often be made to a client's plan to address any 2010 estate tax issues. Each situation is unique, so it is important to determine the impact of such an amendment prior to it being implemented.

### C. GENERATION-SKIPPING TRANSFER TAX ISSUES IN 2010

Another issue impacting decedents dying in 2010 and individuals making gifts in 2010 is the generation-skipping transfer ("GST") tax. Under current law, the GST tax is not applicable to transfers made during 2010. Unless the statute is amended, transfers made to skip persons during 2010 will not generate a GST tax. As a result, individuals can make gifts directly to skip persons during 2010 without triggering GST taxes. Clients should also consider making distributions out of Nonexempt Trusts to skip persons since such distributions should not be subject to GST taxes in 2010.

The one-year repeal of the GST tax also means that GST exemption may not be allocated to gifts made to trusts during 2010. With regard to existing trusts that are currently GST exempt, making gifts to these types of trusts in 2010 may jeopardize the GST exempt status of the trusts. This is because the IRS could argue that a gift made in a year that no GST exemption could be allocated would cause the trust to only be partially GST exempt. Therefore, caution should be exercised before gifts are made to GST exempt trusts during 2010.

With regard to life insurance trusts, or other trusts which might require annual gifts, one option is to make a loan to the trust in lieu of the gift. The donor can make a short-term (less than three years) loan to the trust and charge interest at the short-term applicable federal rate in effect on the date of the loan. In January of 2011, when the GST exemption comes back into effect, the donor can make a gift to the trust in an amount sufficient to allow the trust to pay off the balance of the loan, including interest. The donor can allocate GST exemption to the gift, ensuring that the trust remains GST exempt.

For new trusts, similar procedures can be followed. If a gift is made to a trust established during 2010, the donor should consider making a late allocation of GST exemption effective January 1, 2011. To do this, the donor would file a gift tax return reporting the late allocation, and an amount of GST exemption equal to the value of the trust assets on January 1, 2011 would be allocated to the trust. As a result, the donor could ensure that the trust was GST exempt. In order to make a late allocation of GST exemption, the gift tax return must be filed in the same month of the effective date of the allocation.

### D. SUNSET PROVISIONS AFFECTING 2010 LAWS

The statute currently states that the 2010 estate, gift, and GST tax laws are scheduled to sunset on December 31, 2010. As a result, on January 1, 2011, the law in effect prior to the passage of EGTRRA will spring back to life. Under those rules, the estate tax exemption will be $1 million, the highest estate tax rate will be 55%, and the GST exemption will be $1 million, indexed for inflation from 1997. Specifically, EGTRRA provides that the Act will not apply to decedents dying, gifts made, or GST transfers after December 31, 2010 and that the Code will be applied to decedents dying, gifts made, and GST transfers occurring after December 31, 2010 as if EGTRRA had never been enacted.

Some commentators have suggested that the language of the sunset provisions indicates that, in 2011 and later, the law will be applied as if EGTRRA never existed, even with respect to transfers made before December 31, 2010. In other words, beginning on January 1, 2011, we would look back on transfers occurring prior to January 1, 2011 as if EGTRRA had never been enacted and pre-EGTRRA law was in effect at the time of the transfer. If the law is interpreted this way, it could have both positive and negative impacts. For gifts made in 2010, the law would apply as if the GST tax existed during 2010 and could be allocated to gifts made during that year. This would help alleviate some of the uncertainty related to gifts made to existing GST exempt trusts during 2010.

On the other hand, if the law is treated to have always existed as if EGTRRA had never been passed, then the automatic GST exemption allocations (which were part of EGTRRA) that we have relied on for the past ten years would not be applicable, and as a result, many trusts might not be fully GST exempt.

Note that under EGTRRA, in 2004, individuals had $1.5 million of GST exemption available to allocate, which increased to $2 million in 2006, and to $3.5 million in 2009. With regard to decedents passing away in those years, trusts have been funded assuming a certain level of GST exemption. For example, a decedent who died in 2006 may have created a GST exempt trust at his

or her death, to which $2 million of GST exemption was allocated. Under pre-EGTRRA law, the GST exemption would have been a little over $1 million in 2006. If the IRS interprets the sunset provisions to mean that this trust should be examined as if EGTRRA never existed, then the testamentary trust that was thought to be fully GST exempt might actually have an inclusion ratio between zero and one.

In addition, clients have made gifts to GST exempt trusts assuming a certain level of GST exemption. A client may have made $2 million worth of gifts to a trust intended to be GST exempt over the past 10 years. Again, under pre-EGTRRA law, the GST exemption would not be large enough to cover all of the gifts made to the trust, resulting in the trust having an inclusion ratio between zero and one if the IRS interprets the sunset provisions this way.

## II. FAMILY LIMITED PARTNERSHIPS

Valuation discounts associated with interests in family limited partnerships ("FLPs") continue to be an important component of estate planning. Discounts continue to be at historically high levels. FMV Opinions, a national valuation firm, ("FMV") analyzed restricted stock and control transactions during the Great Recession. Their analysis showed that discounts for lack of marketability and lack of control tend to increase when the Chicago Board Options Exchange's Volatility Index (the "VIX"), which is a measure of volatility occurring on the S&P 500 Index, increases.

According to FMV, a VIX of 26.7 reflects discounts that are 5.1% higher than normal so that if a typical discount for a private company during times of normal market risk is 35%, a VIX of 26.7 would indicate a discount of 40%. The VIX reached a high of 48.2 in May of 2010, indicating that valuation discounts will be higher than normal for transfers made during that time. The VIX continues to be in the high 20's, indicating higher than normal valuation discounts. Clients should take advantage of these higher discounts by making transfers of FLP and LLC interests sooner rather than later. It is anticipated that, as the economy improves, the VIX will decrease, along with valuation discounts.

Over the past year, some important cases have been decided that impact the way gifts of interests in FLPs should be structured. These cases highlight the importance of a sufficient amount of time passing between the formation and funding of the FLP and the date of the gift. In addition, the FLP must be structured so that the gift of the FLP interest will qualify as a present interest if the donor intends for the gift to qualify for annual exclusion treatment.

### A. INDIRECT GIFT ARGUMENTS FOR FLP AND LLC INTERESTS

#### 1. *HOLMAN*: SIX DAY WINDOW BETWEEN FORMATION AND GIFT SUFFICIENT DUE TO VOLATILE NATURE OF ASSET

In *Holman v. Commissioner*, 130 T.C. No. 12 (2008), the Tax Court found that there was not an indirect gift where the gift of limited partnership interests was made six days after the partnership

was formed. In that case, Mr. and Mrs. Holman formed a limited partnership and funded it with Dell Computer Corp Stock in 1999. Six days later, they transferred 70.06% of their limited partnership interests to a trust for their children. Annual exclusion gifts were also made in 2000 and 2001 using the limited partnership interests. On their gift tax returns, Mr. and Mrs. Holman took a 49.25% discount when valuing the limited partnership interests.

The IRS argued that the transaction should be treated as an indirect gift of the Dell stock to the trust and that the liquidation restrictions related to the limited partnership interests (and, thus, the valuation discounts) should be disregarded under Section 2703. The Tax Court found that there was no indirect gift that occurred because there was a real economic risk of a change in value between the date of the partnership's funding and the date of the gift due to the volatile nature of the Dell stock. It indicated that this would be a question of fact depending on the type of assets owned by the partnership.

The Tax Court then turned to the Section 2703 analysis. Under Section 2703, an agreement will be recognized for valuation purposes if (1) it is a bona fide business arrangement, (2) it is not a device to transfer property to family members for less than full and adequate consideration, and (3) its terms are comparable to similar arrangements arrived at in arms length transactions. In analyzing the first prong, the court found that the partnership did not qualify as a closely-held business because the only activity it carried on was holding Dell stock, which was not a business. Therefore, the Court found that the arrangement failed the first prong.

The Tax Court then analyzed the second prong by reviewing a specific provision of the partnership agreement, which provided that if a partner made an impermissible transfer, the assignee interest would be redeemed at its fair market value, rather than for a price equal to the assignee's share of the partnership's underlying property value. Since the redemption would occur at a discount, it would benefit the remaining partners, all of whom were members of the Holman family. As a result, the Tax Court found that this provision indicated that the partnership was a device to transfer property to family members for less than full and adequate consideration, which violates the second prong.

Because the Court had found that the first and second prongs of the test were not met, it did not render an opinion on the third prong and determined that the transfer restrictions should be ignored for purposes of valuing the limited partnership interests in this case. The taxpayer appealed the Court's holding under Section 2703. The Eighth Circuit recently affirmed the Tax Court's decision in full (601 F.3d 763 (8th Cir. 2010)).

### 2. *GROSS*: ELEVEN DAYS SUFFICIENT TIME BETWEEN FORMATION AND GIFT TO AVOID INDIRECT GIFT ARGUMENT

*Gross v. Commissioner*, T.C. Memo 2008-221, was another case in which the indirect gift argument was made by the IRS. Here, the partnership was funded with stock and bonds by the taxpayer, and nominal amounts were also contributed to the partnership by her two daughters. Eleven days after the partnership was funded, the taxpayer gifted a 22.25% limited partnership interest to each of her daughters and applied a 35% discount when reporting the gifts on her gift tax

return. Again, the Tax Court found that there was a real economic risk of change in the value of the partnership between the date of funding and the date of the gift. The Tax Court also rejected the IRS's step transaction argument.

### 3. *LINTON*: FORMATION AND GIFTS ON SAME DAY TREATED AS AN INDIRECT GIFT

*Linton v. U.S.*, 104 AFTR 2d 2009-5176 (W.D. Wash.) involved a limited liability company that was funded with cash, municipal bonds, and undeveloped real estate. On the same day that the assets were transferred to the limited liability company, gifts were made to the donor's children. Based on these facts, the Court found that no valuation discount should be permitted with regard to the limited liability company interests. Instead, the gift should be treated as a gift of the underlying assets owned by the limited liability company. The Court noted that the limited liability company's assets are not as volatile as those in the *Holman* and *Gross* cases. In addition, the Court determined that the step transaction would apply to negate valuation discounts in this case.

As these cases illustrate, it is important to let some time pass between the formation and funding of the FLP and the transfer of the FLP interests. According to Steve Akers, a delay of 15 days is probably safe, and others have thought that 30 days is appropriate. Of course, the more volatile the FLP's underlying assets, the shorter the delay that is needed.

## B. ANNUAL EXCLUSION TREATMENT FOR GIFTS OF INTERESTS IN LIMITED PARTNERSHIPS AND LIMITED LIABILITY COMPANIES

FLP interests are often used to make annual exclusion gifts. However, the FLP agreement must be structured properly to ensure that gifts of FLP interests will qualify for annual exclusion treatment.

### 1. *PRICE*: GIFTS OF FLP INTERESTS FAILED TO QUALIFY AS A GIFT OF A PRESENT INTEREST

In *Price v. Commissioner*, T.C. Memo 2010-2 (January 4, 2010), the Tax Court held that gifts of interests in an FLP did not qualify for annual exclusion treatment. In *Price*, the taxpayers – a husband and wife – created an FLP and funded it with stock in the husband's closely held company and commercial property, which was leased to the company. The stock was subsequently sold and invested in marketable securities.

In the years 1997 through 2002, the taxpayers made gifts of interests in the FLP to their children, which were intended to qualify for annual exclusion treatment. The FLP agreement contained the following restrictions:

i. The partners were prohibited from selling their FLP interests without the written consent of all of the other partners, although a limited partner was permitted to sell his or her FLP interests to another partner without consent.

ii. If a partner transferred his or her FLP interest, the other partners had an option to purchase the FLP interest at its fair market value, determined in accordance with the FLP agreement.

iii. The general partner had the discretion to make distributions (although a majority in interest of the partners could direct a distribution to be made). In addition, the FLP agreement stated that the distributions to partners were secondary to the FLP's purpose of achieving its investment objectives.

The IRS argued that, due to these restrictions, the gifts of FLP interests did not qualify for annual exclusion treatment because they did not constitute present interest gifts. The taxpayers' children could not freely transfer the FLP interests they received to anyone other than an existing partner of the FLP. In addition, the taxpayers' children had no right to income from the FLP interests because they could not unilaterally require the FLP to make distributions of income to them.

Based on its analysis, the Tax Court determined that the taxpayers' children did not have the right to presently use, possess, or enjoy the property and, therefore, the gifts did not qualify for annual exclusion treatment.

### 2. *FISHER*: GIFTS OF LLC INTERESTS DID NOT QUALIFY FOR ANNUAL EXCLUSION TREATMENT

In *Fisher v. U.S.*, 105 AFTR 2d 2010-1347 (S.D. Ind.), the IRS argued that gifts of interests in a limited liability company ("LLC") should not qualify for annual exclusion treatment. The LLC's primary asset was undeveloped real estate that was used by the taxpayer's family for recreational purposes. The LLC agreement provided that, if interests in the LLC were transferred to non-family members, the LLC had a right of first refusal for an amount equal to the price offered by the proposed transferee. If the right of first refusal was exercised, the LLC had 120 days to close, and the payment could be made over a 15-year period. LLC interests could be transferred to family members without triggering the LLC's right of first refusal, but even those transfers were subject to some restrictions according to the court's opinion.

The court found that these restrictions were sufficient to prevent the donees from transferring their LLC interests in exchange for immediate value. As a result, the annual exclusion treatment for the gifts of the LLC interests was disallowed.

### 3. AVOIDING THE APPLICATION OF *PRICE* AND *FISHER*

There are a number of ways that taxpayers can attempt to avoid the application of the *Price* and *Fisher* analyses to the taxpayer's gifts of FLP and LLC interests. One option is to give the recipient of the FLP interest the right to sell the interest to anyone for a period of time, such as sixty or ninety days. This would give the recipient the immediate ability to liquidate the FLP interest, allowing the recipient the ability to presently use and enjoy the property. Therefore, the gift should qualify as a present interest.

A second option is to include a put right in the FLP agreement. A put right would allow the recipient to require the FLP to buy the recipient's interest for a period of sixty or ninety days after receiving the FLP interest. The agreement could state that the purchase price of the FLP interest subject to a put right would be the fair market value of the FLP interest, determined by taking into account all applicable valuation discounts. The FLP agreement should also provide that the purchase price will be paid with cash or other liquid assets, in order to ensure that the donee will be treated as having the right to presently use and enjoy the property.

A third option is for the donor to give a put right to the donee when the FLP interests are gifted (including the put right in the assignment document, rather than the FLP agreement). In this case, the donee would have the right to require the donor to purchase the donee's FLP interest for a period of sixty or ninety days after the gift. As with the put right granted by the FLP, the put right granted by the donor should require the donor to pay the purchase price with cash or other liquid assets.

There is some question whether giving the donee a put right (whether in the FLP agreement or by the donor in the assignment document) would impact the value of the FLP interest for purposes of calculating the value of the gift, which centers on whether the existence of the put right would cause valuation discounts to be lower. However, since the annual exclusion amount is relatively small, it is unlikely that a reduced valuation discount would have a significant impact on the value of the gift.

## III. GIFT TAX EXEMPTION IN 2010

Although EGTRRA repealed the estate tax during 2010, it did not repeal the gift tax. Individuals continue to have a $1 million gift tax exemption, and gifts made in 2010 that exceed the exemption amount will be taxed at a rate of 35%. In 2009, the top gift tax rate was 45%.

While the gift tax exemption is typically referred to as an "exemption," individuals actually have a gift tax credit amount that is equal to the gift tax on $1 million worth of property gifted. The credit is calculated based on the tax rate in effect for the year during which the gift is made. As a result, the reduced gift tax rate that applies to gifts made in 2010 will impact the amount of property that can be transferred as a gift in 2010 before the taxpayer will be required to pay gift taxes.

If an individual has made more than $500,000 in taxable gifts prior to 2010, the gift tax credit used in the past against prior gifts was based on a higher rate than the 35% rate that applies in 2010. As a result, the individual will not be able to make another $500,000 in gifts without paying gift taxes.

For example, if an individual has gifted $600,000 worth of property prior to 2010, then he has used $192,800 of his credit. During 2010, the gift tax credit is $330,800, so the individual will only have $138,000 ($330,800 – $192,800) of his credit remaining in 2010. Based on a 35% gift tax rate, the gift tax credit of $138,000 represents a gift amount of $394,286 ($138,000 ÷ 35%). The total amount that the individual can gift through 2010 without paying gift taxes will be $994,286 ($600,000 + $394,286).

Alternatively, assume an individual made $950,000 worth of taxable gifts prior to January 1, 2010. If the individual makes a taxable gift of $50,000 in 2010 (intending to "use up" his lifetime gift tax exemption), he would owe gift taxes of $12,700 [($326,000 credit used in prior years +$17,500 gift tax on $50,000 in 2010) – $330,800 gift tax credit amount for 2010].

A donor who has made taxable gifts before 2010 of about $961,000 will not be able to make additional gifts during 2010 without paying gift tax. While these amounts are relatively small, it is important to be aware of how the gift tax credit is computed so that a client is not unexpectedly required to pay gift taxes.

This calculation can benefit clients who make large gifts in 2010. For example, a donor who has made no taxable gifts prior to 2010 can make a $1 million gift in 2010 without paying gift taxes. The use of the gift tax credit will be computed based on the 35% tax rate in effect for 2010. Under current law, the gift tax rate will increase for gifts made after December 31, 2010. Assuming a maximum rate of 45% in 2011 and later, the individual will be able to make an additional gift of approximately $36,000 in 2011 or later without paying gift taxes.

## IV. BENEFITS OF GIFT PLANNING DURING 2010

The continued convergence of low interest rates, depressed asset values, and valuation discounts makes 2010 an ideal time to engage in gift planning. Coupled with these factors is the fact that the gift tax rate for taxable gifts made during 2010 is only 35%. In 2009, the maximum gift tax rate was 45%, and in 2011, the maximum gift tax rate will be 55%. This allows individuals to transfer more assets to future generations with less gift tax in 2010.

### A. BENEFITS OF PAYING GIFT TAX DURING LIFE

It is mathematically better to pay gift tax during life than to pay estate tax at death. When the gift tax is imposed, it is computed with regard to the value of the asset gifted. The donor then transfers the asset to the beneficiary and pays the gift tax out of other assets. As a result, both the asset gifted and the cash used to pay the gift tax are outside of the donor's estate (provided that the donor lives three years after the date of the gift). Unlike gift tax dollars, estate tax dollars will be in the donor's estate and will also be subject to estate taxes at the donor's death. The gift tax is "tax exclusive," whereas the estate tax is "tax inclusive."

Not only is it better to transfer assets to pay gift taxes during life, but it is also important for clients to consider transferring assets that are subject to valuation discounts and have appreciation potential. Because discounts are on the chopping block and asset values are at all-time lows, gifts should be made sooner rather than later to take advantage of these circumstances.

Below are several examples of how making gifts and paying gift taxes during life can ultimately affect the amount of assets passing to an individual's heirs.

Lifetime Gift of Discounted Asset. For example, assume an individual wants to transfer a limited partnership interest representing $5 million worth of underlying assets to his children. Assuming a 40% valuation discount, the partnership interest will be valued at $3,000,000 [$5 million x (1 – 40%)]. If the individual gifts the partnership interest, the gift tax will be $1.05 million [$3 million x 35% (based on a 35% tax rate and assuming the individual has no remaining lifetime gift tax exemption)]. As a result, a total of $4.05 million will be transferred out of the individual's estate, $3 million of which will be transferred as a limited partnership interest that represents $5 million of underlying assets to the children.

Hold the Asset until Death and Valuation Discount Applies. Instead, assume that the individual dies owning $4.05 million – a $3 million partnership interest (representing $5 million of underlying property) and $1.05 million in cash. Assuming a 45% estate tax rate, the estate tax liability will be $1,822,500 ($4.05 million x 45%). After paying estate taxes, the estate will be left with $4,227,500 [$5 million (the undiscounted value of the partnership interest) + $1.05 million cash – $1,822,500] available to pass to the children. By holding the asset until death, $772,500 [$5 million (the undiscounted value of the partnership interest) – $4,227,500] less will pass to the individual's children (when compared to making the gift during life). This example assumes that valuation discounts are still available when the individual dies.

Hold Asset until Death but No Valuation Discount Applies. However, if valuation discounts are not applicable at the decedent's death, then the limited partnership interest would be valued at $5 million for estate tax purposes. As a result, the individual would own $6.05 million of assets for estate tax purposes – a $5 million undiscounted partnership interest and $1.05 million in cash. Assuming a 45% estate tax rate, the estate tax liability would be $2,722,500 ($6.05 million x 45%). After paying estate taxes, the estate will be left with $3,327,500 ($6.05 million – $2,722,500) available to pass to the children. By holding the asset until death and not having the benefit of valuation discounts, $1,672,500 [$5 million (the undiscounted value of the partnership interest) – $3,327,500] less will pass to the individual's children (when compared to making the gift during life while valuation discounts were applicable).

Below is a summary of the above examples illustrating the impact that making gifts during life can have on the ultimate amount that will pass to the heirs:

| | **Lifetime Gift of Discounted Asset** | **Hold Asset Until Death; Valuation Discount Applies** | **Hold Asset Until Death; No Valuation Discount** |
|---|---|---|---|
| Assets Subject to Tax: | | | |
| Discounted LP Interest | $ 3,000,000 | $ 3,000,000 | - |
| Undiscounted LP Interest | - | - | $ 5,000,000 |
| Cash | - | 1,050,000 | 1,050,000 |
| Total | 3,000,000 | 4,050,000 | 6,050,000 |
| Tax Rate | 35% | 45% | 45% |
| Taxes Paid | $ 1,050,000 | $ 1,822,500 | $ 2,722,500 |
| Amount Passing to Heirs (undiscounted) | $ 5,000,000 | $ 4,227,500 | $ 3,327,500 |

Appreciation that occurs with respect to the partnership interest during life is ignored in the above examples. Any appreciation that the limited partnership enjoys during the individual's life will serve to increase the amount of estate taxes paid at death and, thus, decrease the amount of the assets that ultimately pass to the children.

Some clients are hesitant to make taxable gifts during life, especially during 2010 when the possibility exists that Congress could enact retroactive legislation to increase the gift tax rate above 35%. To protect against the risk of retroactive legislation, but still take advantage of lower gift tax rates, a client can create an inter-vivos QTIP trust for the benefit of his or her spouse. The client will have until April 15, 2011 to decide whether to make the QTIP election. If the gift tax rate remains at 35%, the election would not be made and gift taxes would be paid based on that rate. If the gift tax rate is raised, the client can choose to make the QTIP election and forego paying gift taxes.

Because of the benefits of paying gift taxes during life, clients should consider making taxable gifts as part of their estate plan. In addition to transferring more assets to future generations, making taxable gifts during life allows the client to shift the appreciation on the gifted assets out of his or her taxable estate.

It is important to note that an individual must use up his or her lifetime gift tax exemption before gift taxes will be paid. If the individual splits gifts with his or her spouse, then both the individual and the individual's spouse must use up their lifetime gift tax exemptions before gift taxes will be paid.

### B. "NET" GIFTS

An alternative to the donor paying gift taxes is to make a "net" gift. Revenue Ruling 75-26 permits the gift tax paid by the transferee to be deducted from the value of gifted property "where it is expressly shown or implied that payment of tax by the donee or from the property itself is a condition of the transfer." In a net gift, the transferor and the transferee enter into a net gift agreement, in which the transferee agrees to pay any gift tax resulting from the transfer, including any additional gift tax resulting from an audit.

The transferee can be an individual or an irrevocable trust. It is important to consider whether the transferee has sufficient liquid assets to pay the gift tax and structure the gift appropriately. If the transferee does not have sufficient liquid assets to pay the gift tax, the transferor can make a loan to the transferee in an amount large enough to allow the transferee to pay the gift taxes. The loan could be structured as a 9-year note with interest at the mid-term applicable federal rate, which is 2.35% for loans made during July of 2010.

The formula for calculating the net gift tax rate is: Tax Rate ÷ (1 + Tax Rate). For example, if the gift tax rate is 35%, the net gift tax rate will be 25.93% (0.35 ÷ 1.35). Assume an individual makes a $2.7 million net gift to his children. The individual would transfer $2.7 million worth of assets to his children and enter into a net gift agreement, where the children agree to pay the gift taxes on the transfer. Based on a 35% gift tax rate, the net gift tax rate would be 25.93%. The gift tax paid by the children would be $700,000 ($2.7 million x 25.93%), leaving the children with $2,000,000 after paying gift taxes.

In the example above, a parent makes a $2.7 million net gift to his child, where the child pays $700,000 in gift taxes and nets $2 million. Alternatively, the parent can make a $2 million gift to his child and pay $700,000 in gift taxes out of his own assets. In both examples, the parent's estate is reduced by $2.7 million and the child's estate is enriched by $2 million.

Making net gifts may appeal to individuals who have a psychological aversion to paying taxes. By structuring the gift as a net gift, the donor does not have to write a check for the gift taxes. In addition, if the amount of the gift is increased by the IRS, the children will be required to pay the additional gift taxes, rather than the donor. Net gifts may also appeal to individuals who do not have the liquidity to pay gift taxes, but whose children or trusts benefitting the children have sufficient liquidity to cover the gift taxes.

## V. ESTATE FREEZE PLANNING

Many gift and estate planning techniques exist that do not require the payment of gift taxes. These techniques generally focus on "freezing" the value of the client's estate and shifting appreciation on assets to future generations or trusts that will not be subject to estate taxes at the client's death. Some examples of estate freeze techniques include sales to grantor trusts, grantor-retained annuity trusts ("GRATs"), and 678 Trusts, which are discussed in more detail below.

## A. SALE TO GRANTOR TRUSTS

In a grantor trust structure, that the grantor will continue to personally pay the income taxes on the income generated by the trust's assets, which allows the trust to grow without being depleted by income taxes. The grantor's payment of these taxes is not treated as a gift to the trust. Studies have shown that, in many cases, this single aspect of a grantor trust has an even greater impact on the grantor's ability to shift wealth to future generations than discounts. Therefore, as discounts are limited or even eliminated, structuring irrevocable trusts as grantor trusts continues to be an extremely effective way of shifting significant wealth to future generations with minimal gift and estate tax cost.

In the sale to a grantor trust technique, the grantor creates a Trust and sells assets to it in exchange for a promissory note. The Trust generally has a longer time over which to pay off the promissory note (typically up to 9 years). The steps involved in creating and implementing a grantor trust are as follows:

1. Grantor creates GST-exempt Grantor Trust for the benefit of the grantor's children and grandchildren. The grantor trusts could be structured as dynasty trusts. Not only do dynasty trusts help minimize estate taxes for future generations, but they also protect the trust assets from beneficiaries' creditors, spendthrift tendencies of beneficiaries, and spouses in the event a beneficiary's divorce. The trustee of the trust controls the investment and distribution of the trust assets. If a beneficiary's access to trust assets needs to be minimized, the trust can be drafted with restrictions and a third party can serve as trustee.

2. Grantor makes a seed gift to the Trust (or arrange for guaranties from the children or other trusts), typically in an amount equal to 10% or more of the entire transaction.

3. Assign LP units to the Trust (units of a limited partnership funded with some of the grantor's investments).

4. Trust signs a promissory note payable to the grantor in an amount equal to the value of the assets sold to the Trust. The interest rate on the note would be equal to the mid-term AFR (which is 2.35% for July) for a 9-year note.

5. Obtain an appraisal of the LP units.

6. File a gift tax return reporting the sale to the Trust and allocate GST exemption to the seed gift. This will begin the running of the 3-year statute of limitations within which the IRS must audit the transaction.

7. As the Trust has liquidity, it makes note payments.

Some risks associated with this technique include the risk of IRS challenge and whether the sale will be respected. In order to bolster the sale, it is important to ensure the trust has adequate creditworthiness to support the sale. The grantor can do this by making a sufficient seed gift to the trust in order to provide equity to support the sale. In addition, the trust beneficiaries or other trusts can serve as guarantors on the note owing back to the grantor and should receive a nominal guarantee fee for doing so (typically 3% of the amount guaranteed).

While the typical structure of the promissory note owing to the grantor is a 9-year term requiring annual payments of interest, if the grantor has a shortened life expectancy, the promissory note could be structured as a self-cancelling installment note ("SCIN"). In addition, the grantor should consider hedging against a revaluation of the LP units by using *McCord* clauses, which are discussed in more detail later in this outline.

Example:

Stock with a value of $1 million is transferred to a limited partnership ("LP"). The LP units have a value of $700,000, assuming a 30% valuation discount. The LP units are sold to a Grantor Trust for a note in the amount of $700,000. The note requires annual payments of interest at a rate of 2.35%, and a balloon principal payment at the end of 9 years.

The stock owned by the LP generates approximately $50,000 per year in dividends, all of which will be taxed on the grantor's income tax return.

After 2 years, the assets owned by the LP have grown to $1.5 million. The Trust's financial picture would be as follows:

| | |
|---|---|
| LP units w/ underlying value of: | $1,500,000 |
| Dividends ($50,000 x 2 years):* | 100,000 |
| Note payable, principal balance: | (700,000) |
| Interest payment, year 1: | ( 16,450) |
| Interest payment, year 2: | ( 16,450) |
| Amount removed from estate: | $ 867,100 |
| | |
| Estate Tax savings (assuming 45% tax rate): | $ 390,195 |

This kind of planning helps prefund the children's inheritance. By setting aside assets for future generations now, the children and grandchildren do not have to wait until their parent or grandparent dies to enjoy the assets. The amount set aside in this way is further compounded through the use of grantor trusts because the grantor pays the income tax liability for the trust out of his or her own assets, as discussed above. As long as the grantor is amenable to paying the trust's income taxes, the trust will get a free ride on the income taxes and can grow without being depleted by them.

If a family is charitably inclined, this type of planning can also allow the family to make substantial charitable gifts after the parents die, especially since the children will already have substantial wealth at that time. Many times, a client's "optimal plan" may involve setting aside a portion of the estate for descendants and the remainder of th estate for charity. By funding the portion passing to descendants during life, the client can leave the assets remaining at his or her death directly to charity, thus eliminating estate taxes and the IRS as an "heir" of the estate. The charity that will receive the assets can be a private foundation created by the client during life or at death. Under this structure, the children receive two inheritances – one as a beneficiary of the grantor trust for the children to spend and enjoy personally. The second is as a director of the family foundation where the child can help perpetuate the family's name and charitable impact by doing public good.

### 1. STRUCTURING A GRANTOR TRUST

The following are some methods to design the Grantor Trust so that the grantor will be treated as the owner for income tax purposes:

a. Spouse as Beneficiary. If the Trust provides that the spouse is a permissible beneficiary of income and principal, then the Trust should be treated as a grantor trust in its entirety. Sections 677(a)(1) and (2).

b. Power of Grantor to Borrow from Trust. If the Trust provides that a grantor can borrow from the Trust without providing adequate security for the loan, the Trust will be treated as a grantor trust. Section 675(2).

c. Actual Loan from Trust to Grantor. If the Trust makes a loan to the grantor or the grantor's spouse and the loan is not adequately collateralized, or in the case of a loan to the grantor's spouse, then loan does not require provide for adequate interest, the Trust will be treated as a grantor trust. Section 675(3).

d. Payment of Insurance Premiums. If the principal and income of the Trust can be used to pay life insurance premiums on the life of the grantor or his spouse, then the Trust should be treated as a grantor trust. Section 677(a)(3). The IRS has gone back and forth on the issue of whether just the ability of the trustee to use trust income to make life insurance premium payments on the life of the grantor is sufficient to cause the Trust to be treated as a grantor trust, or whether actual use of the trust income to make such payments is necessary.

e. Substitution of Trust Assets. The ability of the grantor to substitute assets of the Trust for assets of equal value will cause the Trust to be treated as a grantor trust if such power is exercisable in a non-fiduciary capacity without the approval or consent of someone in a fiduciary capacity. Section 675(4)(C). The IRS has refused to rule on the question of whether a power can be exercised in a non-fiduciary capacity on the grounds that it is a question of fact. PLRs 9437022, 9524032, 9642039, and 9713017. However, in Revenue Ruling 2008-22, the IRS did conclude that a grantor's retained power, exercisable in a non-fiduciary capacity, to acquire property held in a trust

by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be included in the grantor's gross estate for federal estate tax purposes under either Section 2036 or Section 2038.

f. Power to Spray Principal and Income. If a majority of the trustees of the Trust are related or subordinate to the trustee and if the trustees have the ability to make discretionary distributions of principal and income, then the Trust will be treated as a grantor trust. Section 674(c).

g. Power to Add Beneficiaries. If a non-adverse party has the power to add beneficiaries to the Trust, the Trust will be treated as grantor trust. Section 674.

## 2. ADVANCED PLANNING WITH SALES TO GRANTOR TRUSTS

### i. *McCord* Clause and Its Effect on Undervaluation

If hard-to-value assets are sold to the Grantor Trust and the IRS successfully argues that the assets were worth more than the sales price, then the grantor may owe gift tax if the grantor has fully utilized his or her lifetime gift tax exemption. One way to mitigate this risk is to use a *McCord* clause. A *McCord* clause can also be used to help further a client's charitable goals.

The *McCord* clause is a valuation adjustment clause that is included in the sale documentation that complies with the holding in *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006). In *McCord*, the taxpayers, a husband and wife, sold all of their limited partnership interests in a certain limited partnership to a GST exempt trust, their sons, and two charitable organizations. The taxpayers directed that a portion of the limited partnership interests equal in value to their remaining GST exemption amounts pass to the GST exempt trust. Second, a portion of the limited partnership interests worth approximately $6.9 million, reduced by the amount passing to the GST exempt trust, would pass to their sons. Third, a portion of the limited partnership interests worth $134,000 would pass to a charitable organization. Fourth, the limited partnership interests remaining after funding the first three gifts would pass to a second charitable organization.

Subsequent to the transfer, an independent appraisal of the limited partnership interests was obtained. Based on this appraisal, the GST exempt trust, the taxpayers' sons, and the charitable organizations entered into a confirmation agreement, in which they agreed on the exact percentage of limited partnership interests allocated to each of them. Under the transfer document, the limited partnership retained a "call" right with respect to the limited partnership interests transferred to the charitable organizations. Approximately three months after the confirmation agreement was signed, the limited partnership exercised its call right and redeemed the charitable organizations' interests in exchange for cash.

The taxpayers filed a gift tax return reporting this transaction. When the gift tax return was later audited, the IRS argued that the value of the limited partnership interests that actually passed to the GST exempt trust and the taxpayers' sons (collectively, the "noncharitable assignees") was greater than that which was reported on the gift tax return. The IRS's argument was successful in the Tax Court, which found in the IRS's favor. The case was appealed to the 5th Circuit.

The 5th Circuit ultimately held that the fair market value of the limited partnership interests must be determined as of the date of the gift and is not affected by subsequent events. Therefore, the confirmation agreement must be ignored and the IRS could not consider the exact percentage of partnership interests transferred to the noncharitable assignees. Rather, the IRS was bound by the formula clause, which directed that a portion of the limited partnership interests equal in value to approximately $6.9 million pass to the noncharitable assignees. As a result, the taxable portion of the gift would not be greater than $6.9 million.

The *McCord* clause allows the client to give and/or sell a specific amount of property to the grantor trust while, at the same time, transferring an amount to a charity of the client's choosing. If the value of the property gifted and/or sold is later determined to be higher than the appraised value, that additional value is also attributed to the charity. Thus, if the value of the property is redetermined by the IRS, the additional value transferred would qualify for the charitable gift tax exemption.

*McCord* clauses involve careful and intricate drafting, as well as specific procedures to make sure that the charity and the grantor trusts deal with each other at arm's length. We have utilized the *McCord* technique for several clients with appreciating assets who wanted to transfer a portion of the assets in a way that would benefit subsequent generations and one or more charitable organizations. First, the clients form a grantor trust, naming their descendants as beneficiaries and gifted a nominal amount of cash to the trust. The clients then sell a portion of the asset to the trust and the remainder to a donor-advised fund.

The transfer document directs that an amount of the assets with a value equal to a certain dollar amount (assume $1 million for illustration purposes) will pass to the trust. The remaining amount of the assets will pass to the donor-advised fund. The trust executes a promissory note promising to pay $1 million to the clients in exchange for its share of the assets. The portion passing to the donor-advised fund is treated as a charitable gift. A gift tax return should be filed allocating GST exemption to the cash gift and reporting the above sale to the grantor trust.

The trust and the donor-advised fund subsequently agree on an allocation of the shares, based on an appraisal that was performed by an independent appraisal firm. Over time, the trust repays the promissory note. After the note is paid in full, the trust is left with the appreciation on the assets. By using this technique, clients can make these types transfers free of gift tax and using a minimal amount of their GST exemptions.

### ii. *McCord* Clause Options

Option 1: Appraisal Obtained Prior to the Transfer

The Assigned Interest shall be allocated among the Assignees in the following order:

(a) that portion of the Assigned Shares having a fair market value as of the Effective Date equal to _____

Dollars ($_____) is assigned to the Trustee of the Irrevocable Trust; and

(b) any remaining portion of the Assigned Interest is assigned to the Accepting Charity;

For purposes of this paragraph, the fair market value of the Assigned Shares as of the Effective Date shall be the price at which the Assigned Interest would change hands as of the Effective Date between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts for purposes of Chapter 12 of the Internal Revenue Code of 1986, as amended.

Option 2: Client Transferring a Specific Dollar Amount of Assets and Appraisal will be Obtained after Transfer

Note: In this example, the term "Assigned Interest" is defined earlier in the document as a certain dollar amount of assets (e.g., $50 million).

The Assigned Interest shall be allocated among the Assignees in the following order:

(a) that portion of the Assigned Interest having a Fair Market Value (as defined below) as of the Effective Date equal to $_____ is assigned to the Trustee of the Irrevocable Trust; and

(b) any remaining portion of the Assigned Interest is assigned to the Accepting Charity.

For purposes of this Assignment Agreement, the "Fair Market Value" of any asset is the price at which the asset would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or sell and both having knowledge of the relevant facts. Whenever the term "Appraised Value" is used in this Agreement, it shall refer to the Fair Market Value as determined by the Appraiser and shall not be redetermined in the event that the actual Fair Market Value is later determined to be different from the Appraised Value.

All parties to this Assignment Agreement acknowledge that valuation is a difficult discipline and the actual Fair Market Value of any asset may or may not be equal to the Appraised Value. Nevertheless, the portion of the Assigned Interest that passes to the Trustee of the Trust, shall be that portion of the Assigned Interest that has an actual Fair Market Value equal to $_____. This formula could result in the Accepting Charity ultimately receiving substantially less than or more than $_____ if it is later determined that the Appraised Value is inaccurate.

Option 3: Client Transferring All of His or Her Interest in a Specific Asset (i.e., a Limited Partnership Interest or a Certain Number of Shares of Stock) and Appraisal will be Obtained after the Transfer

The Assigned Interests shall be allocated among the Assignees in the following order:

(a) that portion of the Assigned Interests having an actual Fair Market Value as of the Effective Date equal to the difference between (i) the Appraised Value and (ii) Five Hundred Thousand Dollars ($500,000.00) is assigned to the Trustee of the Irrevocable Trust; and

(b) any remaining portion of the Assigned Interests is assigned to the Accepting Charity.

For purposes of this Assignment Agreement, the "Fair Market Value" of the Assigned Interests as of the Effective Date shall be the price at which the Assigned Interests would change hands as of the Effective Date between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts for purposes of Chapter 12 of the Internal Revenue Code of 1986, as amended.

All parties to this Assignment Agreement acknowledge that the actual Fair Market Value of the Assigned Interests may or may not be equal to the Appraised Value. Nevertheless, the portion of the Assigned Interests that pass to the Trustee of the Irrevocable Trust, shall be that portion of the Assigned Interests that has an actual Fair Market Value equal to the Appraised Value, less Five Hundred Thousand Dollars ($500,000.00). This formula could result in the Accepting Charity ultimately receiving substantially less than or more than Five Hundred Thousand Dollars ($500,000.00) if it is later determined that the Appraised Value is inaccurate.

### iii. Self-Cancelling Installment Notes

Using a self-cancelling installment note ("SCIN") may be appropriate where the client is concerned whether he will outlive the term of the note to the grantor trust. A SCIN is a debt obligation which will terminate upon the seller's (grantor's) death, with any remaining balance payable by the purchaser (trust) automatically cancelling, potentially saving millions of dollars in estate taxes. In order to compensate the seller for the risk of cancellation, the SCIN must have a risk premium, which can be in the form of a higher interest rate or a higher sales price. With today's extremely low applicable federal rates, the SCIN premium is not nearly the deterrent that it is in a higher interest rate environment.

There should be no gift upon the sale of the assets in exchange for the SCIN provided that the interest rate or principal is adjusted to compensate the seller for the self-cancelling feature.

NumberCrunchers is an estate planning/financial planning software that performs the calculations as to what an appropriate interest rate or principal premium should be.

For example, assume a client who is 60 years old sells an asset worth $1 million to a grantor trust in exchange for a SCIN with a 9-year term. Based on a 2.8% Section 7520 rate and a 2.35% mid-term AFR (both effective for transactions occurring in July 2010), and assuming that the SCIN would be self-amortizing, the principal risk premium would be $80,485, resulting in the SCIN having a principal amount of $1,080,485 and an interest rate of 2.35%. The interest risk premium would be 1.6669%, resulting in the SCIN having a principal amount of $1,000,000 and an interest rate of 4.0169%.

The SCIN can be structured many different ways, depending on a client's specific situation. The note can be self-amortizing, require level principal payments, or require payments of interest only with a balloon payment of principal at the end of the note term. Each structure will require a different principal or interest risk premium and should be analyzed carefully before the final structure is chosen.

Since the note cancels upon the death of the seller, the note has no value for purposes of computing the seller's gross estate. The use of a SCIN was recognized as a bona fide sale by the Sixth Circuit in *Costanza v. Commissioner*, 320 F.3d 595 (6th Cir. 2003), *rev'g* TCM 2001-128. The Sixth Circuit Court of Appeals held that a sale utilizing a SCIN was a bona fide sale of property; however, the Sixth Circuit remanded the case back to the Tax Court to determine if any portion of the SCIN was a "bargain sale" and therefore partially a taxable gift.

### B. GRANTOR RETAINED ANNUITY TRUSTS

A grantor retained annuity trust ("GRAT") is a trust designed to comply with the requirements of Section 2702 of the Code. Section 2702 provides that for purposes of determining whether or not a transfer in trust for the benefit of one or more members of the grantor's family is a gift, the value of the interest retained by the grantor will be valued at zero unless the interest is a qualified interest.

1. Payments to the grantor must be made at least annually. § 2702(b)(1).

2. The payments must be either a fixed amount (annuity) or a fixed percentage of the fair market value of the assets transferred to the GRAT at the date of transfer (unitrust). Treas. Reg. § 25.2702-3(b)(1)(ii).

3. Payments from one year to the next may not increase by more than 20%. Treas. Reg. § 25.2702-3(e), Example 2.

4. The trust agreement must prohibit additional contributions from being made to the trust. Treas. Reg. § 25.2702-3(b)(4).

5. The trust agreement must prohibit commutation of the interest of the grantor.

### 1. GIFT TAX IMPLICATIONS

Assuming that the Section 2702 requirements are satisfied, then the annuity or unitrust interest retained by the grantor will be a qualified income interest. The value of the remainder interest will be treated as a taxable gift from the grantor to the remainder beneficiaries of the GRAT. The amount of the taxable gift is affected by the following factors:

- Term of the GRAT. The longer the term of the GRAT, the lower the value of the remainder interest.

- Section 7520 Rate. The higher the §7520 rate, the higher the value of the remainder interest. Therefore, lower §7520 rates generate lower gift tax costs.

- Annuity or Unitrust Amount. The higher the annuity or unitrust amount paid to the grantor each year, the lower the value of the remainder interest.

### 2. ZEROED OUT GRAT

The Tax Court decision in *Walton v. Commissioner*, 115 TC 589 (2000), now effectively allows a taxpayer to "zero-out" a GRAT – meaning that the remainder interest would be valued at zero or slightly in excess of zero depending upon the manipulation of the factors discussed in Section 1 above. Obviously, the grantor cannot adjust the Section 7520 rate, so the grantor will have to manipulate the term of the GRAT and the payout amount in order to effectively zero out the GRAT.

### 3. IDEAL ASSETS

The ideal assets to be used for a GRAT are those with significant appreciation potential.

- Single Stock. Particularly effective is the creation of a GRAT with a single stock, since a diversified portfolio will likely not have the significant appreciation potential of a single stock. Since a GRAT can be designed to zero out the value of the remainder interest, the grantor will not "waste" lifetime gift tax exemption by allocating to a transfer in which the assets decline in value or fail to grow at a rate in excess of the § 7520 rate. Thus, a grantor could create a series of zeroed out GRATs which are each funded with a single stock. The GRATs in which the stock appreciates in excess of the § 7520 rate will have achieved the goal of transferring value from the grantor's estate with little or no transfer tax cost. From a transfer tax perspective, the grantor will not suffer because of the GRATs which have stocks which decline in value or fail to grow in excess of the § 7520 rate. The grantor's only loss will be the professional fees associated with the creation of the GRAT.

- Grant of Option to Acquire Stock. One idea is for the grantor to transfer an option to acquire stock which the grantor owns to a GRAT. The option should be written so that there can be a cash settlement upon exercise of the option. If the underlying stock increases in value, then the trustee of the GRAT will choose to exercise the option.

- Substitution of Low Basis Assets. If a grantor has established a GRAT with low basis assets, the grantor can retain the right in the GRAT to substitute assets of equal value. Thus, a grantor can transfer cash or other high basis assets to a GRAT before the expiration of the term so that the low basis assets might be included in the grantor's taxable estate which will provide for a basis step up at the grantor's death.

### 4. RISK OF GRAT: DEATH OF GRANTOR DURING TERM OF GRAT

If the Grantor dies during the term of the GRAT, then either the fair market value of the assets in the trust will be included in the Grantor's taxable estate under Section 2036, or possibly the value of the assets in the GRAT necessary to produce sufficient income under Section 2039.

### 5. PENDING LEGISLATION AFFECTING GRATS

Many different bills this legislative session have included provisions requiring a 10-year minimum term for GRATs, among other things. The most recent bill was passed by the House on July 1, 2010. H.R. 4899 is a supplemental spending bill which included the following provisions affecting GRATs:

- GRATs must have a term of not less than 10 years.
- The annuity payments, when determined on an annual basis, may not decrease relative to any prior year during the first 10 years of the GRAT's term.
- The remainder interests must have a value greater than zero as of the time of the transfer to the GRAT. Theoretically, a remainder interest of $1 should be sufficient.

Under the terms of H.R. 4899, these provisions will apply to transfers made after the date of the bill's enactment. The bill will be taken up by the Senate next. According to commentators, members of the Senate have strongly indicated that they would like to save provisions affecting GRATs (which will serve as revenue raisers) to offset the cost of future estate tax legislation (e.g., to offset lost revenue if a bill increases the estate tax exemption above $1 million). It is possible that GRAT legislation will not be passed soon, but most believe that it is just a matter of time before legislation like this will become law. Note that the Responsible Estate Tax Action discussed above may also have implications on how GRATs can be structured.

As a result, we are continuing to encourage our clients to take advantage of short-term GRATs while this technique is available. There may still be time to use this technique to transfer wealth to future generations with little or no gift tax cost, but the window of opportunity appears to be closing.

## C. PLANNING WITH 678 TRUSTS

Typically, when a client is considering options to help reduce estate taxes, the client must consider techniques that require the client to part with at least a portion of the assets he or she has accumulated over the years, as well as part with future appreciation. For example, many estate planning techniques involve gifting and/or selling the client's assets to trusts that benefit the client's children. In these situations, it can be difficult to balance the client's desire to reduce estate taxes with the client's need to retain sufficient assets to maintain his or her standard of living.

One vehicle that allows the client to combine asset protection, estate tax savings associated with "estate freeze" techniques, and the continued ability to benefit from assets he or she has accumulated over the years is the "678 Trust." The 678 Trust is named after the Internal Revenue Code Section upon which it is based, which states that a beneficiary who has a withdrawal right under a Crummey trust will be treated as the owner, for income tax purposes, of the portion of the trust over which the withdrawal power lapsed.

### 1. STRUCTURE OF A 678 TRUST

The 678 Trust is established by the client's parents, sibling, or close friend with a gift of $5,000. The client is the primary beneficiary and can receive distributions for health, education, maintenance, and support purposes. The client can also be named as the trustee. The Trust is structured initially as a "non-grantor" or "complex" trust for income tax purposes. Therefore, the 678 Trust is initially a separate taxpayer for income tax purposes. However, the 678 Trust also includes a "Crummey" withdrawal right for the client. If the client refuses to withdraw the initial $5,000 contribution, the 678 Trust becomes a grantor trust as to the client. Thus, all income tax effects of the 678 Trust from that point forward become the responsibility of the client.

As a result, the client can sell assets to the 678 Trust without being required to recognize gain on the sale. In addition, if the client sells assets to the 678 Trust in exchange for a promissory note or loans money to the 678 Trust, the client will not be required to recognize the interest payments as income. This characteristic also causes the 678 Trust to be a permissible owner of S corporation stock, without requiring the Trust to elect to become a qualified subchapter S trust ("QSST") or an electing small business trust ("ESBT").

Furthermore, the client will be responsible for paying the income tax on the income generated by the Trust's assets. Assets outside of the Trust can be used to pay the income taxes, allowing the Trust assets to grow without being depleted by income taxes. This also allows the client to "spend down" assets that would otherwise be includable in his or her estate and subject to estate taxes at death. If the time came that the client were unable to pay the income taxes out of his or her own assets, the 678 Trust could make a distribution to the client in the amount of the income taxes under the health, education, maintenance, and support standard.

## 2. BUILDING VALUE IN THE 678 TRUST

The 678 Trust can be utilized by almost any type of client. The most obvious use of a 678 Trust is for clients who are expecting to purchase an asset that has high appreciation potential, are starting a business, or are expanding an existing business (but as discussed below, it can also be used for existing assets with appreciation potential or that are subject to valuation discounts). Some examples include buying a new business opportunity, engaging in additional drilling operations, or investing in restaurant franchises.

In those cases, the client can make a loan to the 678 Trust to enable it to buy the asset, start the new business, or expand the existing business. In order for the loan to be respected by the IRS, it must carry an interest rate equal to, at a minimum, the applicable federal rate for the type and length of the loan. As the asset or business grows in value, the loan can be repaid. The asset will continue to be owned by the 678 Trust, where it will not be subject to estate tax at the client's death. Once the 678 Trust has built up significant assets, it can simply purchase new assets using its own credit.

The 678 Trust can also be useful for clients who have existing assets that have appreciation potential or that are valued at a discount. In these cases, it might be desirable for the client to sell the asset to the 678 Trust in exchange for a promissory note. For the reasons discussed below, it is important that the sale be structured so that it will be respected by the IRS as a bona fide sale under Section 2036 of the Code. The 678 Trust needs to have sufficient substance to support the sale, which can be problematic if the Trust is new and has not yet built up significant value.

To remedy this situation, the 678 Trust can have other trusts or individuals (other than the client) guarantee the note owing to the client. If no other trusts or individuals are available to guarantee the note, the client can create a separate trust for his or her children and make a $1 million gift (or $2 million if the client is married and gift splits with his or her spouse) to it. The new trust can then provide a guarantee to the 678 Trust in exchange for a guarantee fee. To supercharge the new trust, it can be structured as a grantor trust with respect to the client for income tax purposes and as a GST exempt dynasty trust.

It is important when the client transacts with the 678 Trust that the transaction be structured at fair market value, and that **no gifts be made to the 678 Trust beyond the $5,000 contributed by the client's parents**. Any additional gifts could alter the income tax and estate tax characteristics of the 678 Trust. Furthermore, if the client is treated as having made a gift to the 678 Trust, then the Trust's assets will be subject to estate taxes when the client dies.

In order to guard against the client being treated as having made a gift to the 678 Trust when he or she loans money to the Trust, the interest rate on the loan should be at least equal to the applicable federal rate in effect at the time the loan is made. When assets are sold to the Trust, the sales price must be equal to the fair market value of the asset. Sale documents can include adjustment clauses, where the 678 Trust and the client agree that, if the fair market value of the asset sold to the Trust is ever determined to be different than that agreed upon by the Trust and the client,

the sales price will be adjusted to reflect the differently determined fair market value. This will help avoid the argument that the client made a gift to the 678 Trust if the sales price is determined to be lower than the asset's fair market value.

The 678 Trust can also allow the client to exercise a special power of appointment ("SPOA") over the Trust assets. By possessing an SPOA with respect to the Trust assets, any inadvertent gift that the client may have made to the Trust will be treated as an incomplete gift. Treasury Regulation § 25.2511-2(b) provides that, if a donor transfers property (to a trust or otherwise) but retains the power to control how the property will be disposed of, then the gift by the donor will be incomplete. The SPOA gives the client-beneficiary the power to control how the property will be disposed of at his or her death. As a result, if the client is treated as having made a gift to the 678 Trust, the gift will be incomplete from a gift tax perspective and no gift tax will be due at that time.

Although the gift will be incomplete for gift tax purposes, the gift will cause all of the Trust assets to be included in the client's estate at death because the client will have made a gift to a trust of which he is a beneficiary. As a result, the tax will not be avoided by virtue of the gift being treated as incomplete, it will merely be postponed until the client's death.

The SPOA also gives the client the flexibility to modify the terms of the Trust on his or her death to account for changed circumstances. The SPOA can be so broad as to allow the client to exercise it in favor of anyone (including other individuals, trusts, and charitable organizations) other than the client, the client's estate, the client's creditors, or the creditors of the client's estate.

### 3. RESULTS OF 678 TRUST PLANNING

The 678 Trust should be structured as a GST exempt dynasty trust. When the initial gift is made to the 678 Trust, the client's parents should allocate GST exemption to the Trust, which will allow it to pass to future generations free of transfer taxes. As a result, the assets owned by the Trust should not be subject to estate tax at the death of the client or the client's parents. In addition, the 678 Trust should contain a spendthrift provision, in which case the Trust assets should be protected from the client's creditors.

With regard to assets sold to the 678 Trust, the value of the assets owned by the client are frozen at the value of the note the client received in the sale. The client can spend down these assets by paying the income tax liability generated by the Trust's assets and allow the assets owned by the 678 Trust to grow without being depleted by income taxes.

The Trustee of the 678 Trust has the ability to distribute Trust assets to the client and his or her issue for health, education, maintenance, and support needs, and the client may be given a limited inter vivos or testamentary power of appointment over the assets of the 678 Trust to account for changes in family circumstances or the law. Upon the client's death, the 678 Trust can be drafted to divide into separate trusts for his or her children, and those trusts will be considered "complex" trusts for income tax purposes.

## 4. REPORTING REQUIREMENTS

The creator of the 678 Trust should file a gift tax return reporting the $5,000 gift to the Trust and allocating GST exemption to the gift. The gift tax return will be due on April 15 of the year following the year in which the $5,000 gift is made.

When the client transacts with the 678 Trust, he or she should file a gift tax return disclosing the sale or loan in order to start the running of the 3-year statute of limitations. Assuming that the disclosure is adequate, if the IRS does not audit the gift tax return within the 3-year period, they will be prohibited from challenging the transaction later on. The gift tax return will be due on April 15 of the year following the year in which the transaction takes place.

## 5. EXAMPLES

Example #1: The example below illustrates how the 678 Trust would be structured when the Trust will be investing in a new business, expanding an existing business, or purchasing a new asset from a third party.

Step 1: Client decides to buy a new business, and the purchase price is $100,000.

Step 2: Parents of client ("Mom and Dad") create a non-grantor trust (the "Trust") for the benefit of the client ("Son") and his descendants. Mom and Dad initially fund the Trust with $5,000, and the Trust provides that Son has a Crummey withdrawal right over contributions to the Trust.

Step 3: Son receives notice of withdrawal right and allows the withdrawal right to lapse.

Step 4: Trust creates a limited liability company ("LLC") to purchase the new business. Trust is the sole member of the LLC. [Note: If expanding an exiting business (such as acquiring more product lines or franchises, additional oil and gas drilling, etc.), the new activity will be owned by the new LLC rather than the existing business.]

Step 5: Trust borrows $100,000 from a bank or a third party. Son, Son's existing business, or another trust guarantees the Trust's debt to the bank/third party for a small fee. Alternatively, the Trust can borrow $100,000 from Son directly, with interest on the loan charged at the applicable federal rate.

Step 6: Trust contributes $100,000 to LLC. LLC purchases new business opportunity for $100,000.

Step 7: Mom and Dad file Form 709 Gift Tax Return, reporting a $5,000 gift to Trust and allocating $5,000 of GST exemption to the Trust, making the Trust fully exempt from GST tax.

Step 8: Son manages and grows new business. All of the income from the Trust assets is taxed to Son. If necessary, Son (or his descendants) may receive distributions of Trust income or principal.

Step 9: Trust continues to own and operate business, and has sufficient capital to acquire new business opportunities or other assets. Son and his children can benefit from Trust income or principal. The assets are protected from creditors. At Son's death, if Trust assets are worth $5 million, then Son has saved approximately $2 million in estate tax.

Example #2: The example below illustrates how a 678 Trust transaction would be structured when the 678 Trust plans to purchase an existing business or other asset from the client. This use of the 678 Trust may be a fit for more clients' situations.

Step 1: Client owns a package of investment assets that have high appreciation potential. The package of investment assets is currently worth $15 million.

Step 2: Client contributes the investment assets to a limited partnership (the "LP"). Assuming a 40% valuation discount, the LP interests would be worth $9 million.

Step 3: Client creates a grantor trust for the benefit of client's children (the "Grantor Trust") and makes a gift of up to $1 million worth of LP interests to it. If Client is married, Client's spouse can also make a gift of up to $1 million worth of LP interests to the Grantor Trust. (Note: This step is not necessary if the client has already created trusts for his children that have substantial value.)

Step 4: Parents of client ("Mom and Dad") create a non-grantor trust (the "678 Trust") for the benefit of Client and his descendants. Mom and Dad initially fund the Trust with $5,000, and the Trust provides that Client has a Crummey withdrawal right over contributions to the Trust.

Step 5: Client receives notice of withdrawal right and allows the withdrawal right to lapse.

Step 6: 678 Trust purchases Client's LP interests in exchange for a promissory note. The note is structured as a 9-year note, with interest at the mid-term applicable federal rate. New Grantor Trust (or previously existing trust, if such exists) guarantees at least 10% of the note amount in exchange for a small fee.

Step 7: An appraisal of the LP interests is obtained for the purpose of determining the exact percentage transferred to the Grantor Trust and determining the principal amount of the promissory note owing by the 678 Trust.

Step 8: Mom and Dad file Form 709 Gift Tax Return, reporting a $5,000 gift to Trust and allocating $5,000 of GST exemption to the Trust, making the Trust fully exempt from GST tax.

Step 9: Client files a Form 709 Gift Tax Return, reporting the $1 million gift to the Grantor Trust and reporting the sale to the 678 Trust. A copy of the appraisal should be attached to the Return.

Step 10: All of the income from the Grantor Trust assets and the 678 Trust assets is taxed to Client. If necessary, Client (or his descendants) may receive distributions of income or principal from the 678 Trust. Client's descendants may also receive distributions of income or principal from the Grantor Trust. The assets owned by the 678 Trust and the Grantor Trust are protected from creditors.

Step 11: Trust continues to own the LP, which owns and manages the investment assets. Over time, the investment assets appreciation. At Client's death, if Trust assets are worth $25 million, then Client has saved approximately $7.2 million in estate tax. [Calculated as follows: (i) $25 million less $9 million (the $1 million gifted, which used up lifetime gift tax exemption, plus the $8 million sold, in exchange for which Client received a promissory note that was repaid over time), multiplied by (ii) 45% tax rate.]

The 678 Trust technique helps reduce estate taxes, provides creditor protection, and gives the client the ability to continue to benefit from the assets during his or her life. When compared to other estate planning techniques, such as GRATs (discussed above), the 678 Trust is superior because, among other things, (i) the client does not have to survive the transaction with the 678 Trust by any period of time in order for the assets to be outside of the client's estate, and (ii) the estate tax inclusion period rules do not apply, so that GST exemption can be allocated to the Trust on its creation. The 678 Trust can be structured and customized to fit many different situations.

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1. We must give credit to Stanley Johanson for this astute reference to Charles Dickens. Professor Johanson opened his presentation, Recent Developments Affecting Estate Planning, at the Fort Worth Business & Estate Council Meeting on March 25, 2010 with this quote.

2. David Kocieniewski, *Texas Billionaire's Legacy: Death, but No Taxes*, N.Y. TIMES, June 9, 2010, at A1.

3. Associated Press, *Steinbrenner Heirs May Save Millions on the Estate Tax*, N.Y. TIMES, July 14, 2010.