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MAKING THE MOST OF THE 2011-12 WINDOW OF OPPORTUNITY: TWO CUTTING EDGE TECHNIQUES

PRESENTED TO:
TIGER 21, GROUP DALLAS 02

September 9, 2011

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BIOGRAPHICAL INFORMATION

Marvin E. Blum
Attorney and Founder
The Blum Firm, P.C., Fort Worth, Texas

The Blum Firm, P.C., was established by Marvin Blum over 30-years ago, has law offices in both Fort Worth and Dallas, and specializes in the areas of estate planning and probate, asset protection planning, planning for closely-held businesses, tax planning, tax controversy, and charitable planning. The company has grown to be the largest group of estate planning attorneys in the State of Texas. Mr. Blum is known for creating customized, cutting-edge estate plans, now serving hundreds of high net worth families, several with a net worth exceeding $1 billion. In 2009, Mr. Blum was chosen from hundreds of recommendations across the U.S. serving multiple practice areas as one of the "Nation's Top 100 Attorneys" by New York's *Worth* magazine. He is a highly sought-after speaker and lecturer among his peers, having made numerous presentations to legal and tax professionals. Mr. Blum is highly dedicated to his community and currently serves as Secretary/Treasurer and one of three Board members (along with Emmitt and Pat Smith) of the Pat & Emmitt Smith Charities, a public charity devoted to creating opportunities for disadvantaged children. Mr. Blum is in his 32nd year as Treasurer of the Fort Worth Symphony, and served as Presiding Chair for numerous terms of The Multicultural Alliance, formerly The National Conference of Christians and Jews, a service organization fighting bias, bigotry and racism. Mr. Blum, an attorney and Certified Public Accountant, is Board Certified in Estate Planning & Probate Law and is a Fellow of the American College of Trust and Estate Counsel. He earned his BBA (Highest Honors) in Accounting from the University of Texas in 1974, where he graduated first in his class and was named Ernst & Ernst Outstanding Student in Accounting. Mr. Blum received his law degree (High Honors) from the University of Texas School of Law in 1978, where he graduated second in his class and was named the Prentice-Hall Outstanding Student in Taxation. Mr. Blum and his wife, Laurie, reside in Fort Worth, Texas.

Steven W. Novak
Attorney and Managing Partner
The Blum Firm, P.C., Dallas, Texas

STEVEN W. NOVAK, J.D. is the managing partner of the Dallas office of The Blum Firm, P.C., a Fort Worth based law firm started in 1980 by Marvin Blum. The firm, comprised of fifteen attorneys, specializes in the areas of estate planning and probate, asset protection, and business and tax planning. Seven of the attorneys are also Certified Public Accountants. Eight, including Mr. Novak, are Board Certified by the Texas Board of Legal Specialization in Estate Planning and Probate Law, and two are Board Certified in Tax Law. Before joining The Blum Firm in 2006, Mr. Novak practiced law in Dallas at both Hughes & Luce, LLP, and Meadows, Collier, *et al* LLP. Mr. Novak was born in Fort Wayne, Indiana and received his undergraduate degree in Political Science from the University of Kansas in 1997 and his J.D. from the University of Kansas School of Law in 2001. While attending the University of Kansas School of Law, he was a Note and Comment Editor for the *Kansas Law Review* and the Editor of the *2001 Kansas Criminal Procedure Survey.* Mr. Novak is a member of the Taxation Section and the Real Property, Probate and Trust Section of the American Bar Association. He is also a member of the State Bar of Texas, the Fort Worth Bar Association, the Dallas Bar Association, and the Dallas Association of Young Lawyers. Mr. Novak is a frequent speaker and author on a variety of topics in estate and business planning and was named a “Texas Rising Star” by *Texas Monthly* and *Law and Politics Magazine* in 2006, 2007, 2008, 2009, 2010, and 2011.

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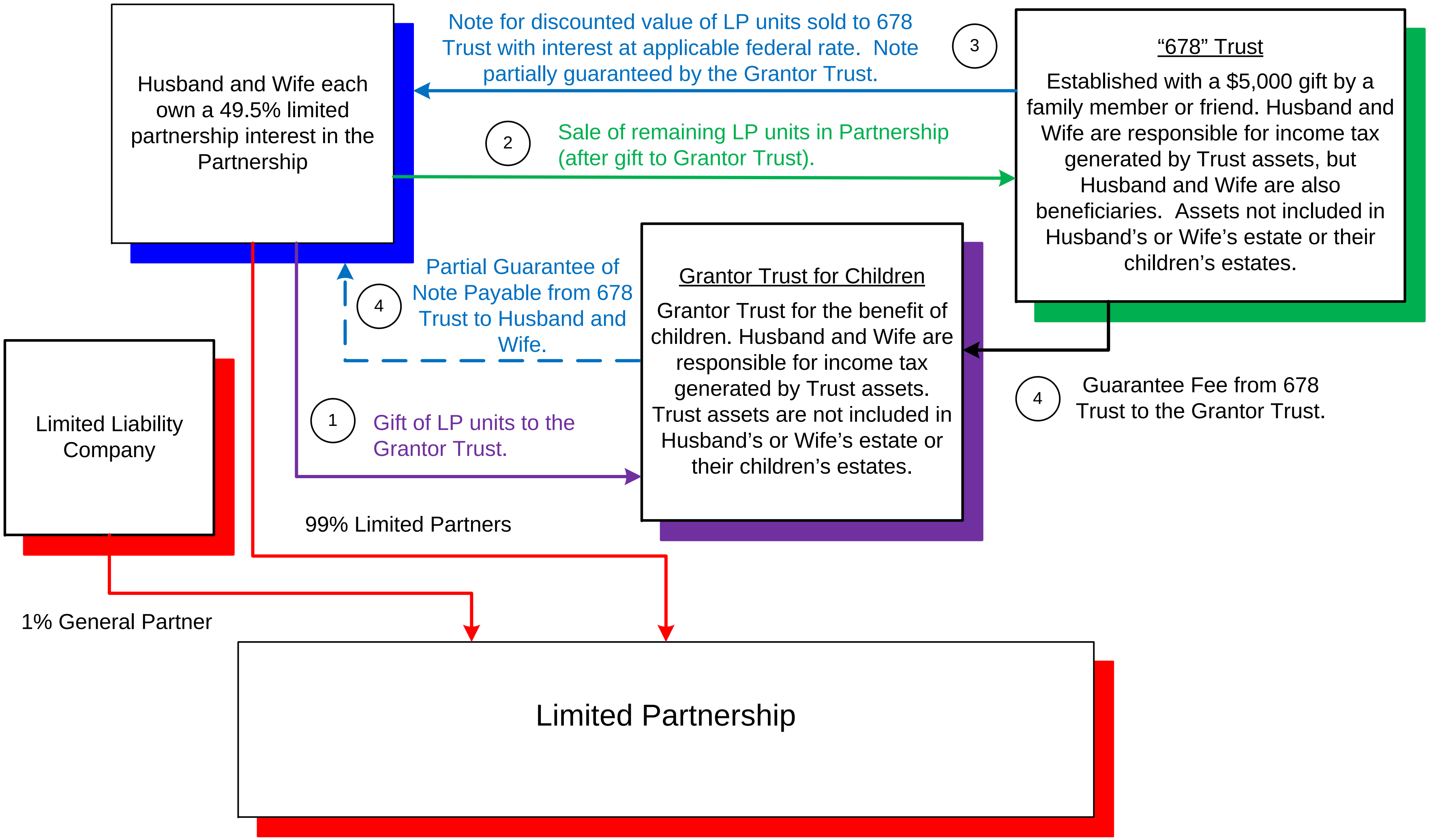
678 TRUST TRANSACTION CHART



<u>Brief Overview of Proposed Transaction:</u>

Husband and Wife are the owners of a 99% limited partnership interest in the Partnership. Husband and Wife make a gift of limited partnership interests in the Partnership to the new Grantor Trust, which will remove those assets from Husband and Wife's estate. The remaining limited partnership interests in the Partnership may then be sold to a new "678" Trust established by a family member or friend. Husband and Wife will be beneficiaries of the 678 Trust, but the 678 Trust's assets will be outside of their taxable estate. Husband and Wife will be left with a note receivable. In essence, Husband and Wife will be "freezing" their interest in the Partnership at its current value, removing any future appreciation and any discount associated with the assets sold/gifted to the 678 Trust and/or the Grantor Trust.

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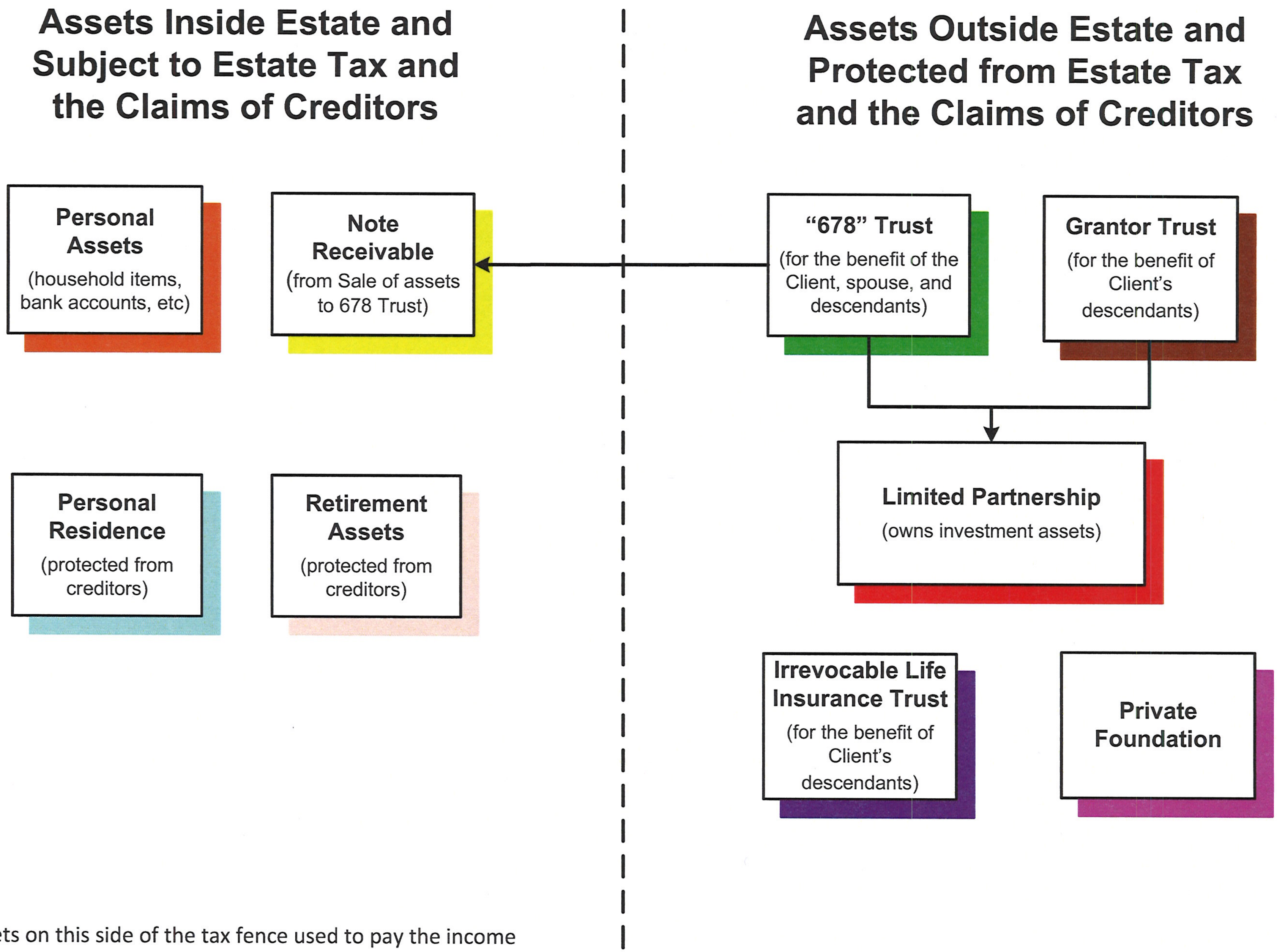
“Tax Fence”



*Assets on this side of the tax fence used to pay the income tax generated by assets held outside the estate.

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EXECUTIVE SUMMARY
G1-G2 SPLIT-DOLLAR LIFE INSURANCE PLANNING

By Marvin E. Blum

Description of Planning Technique

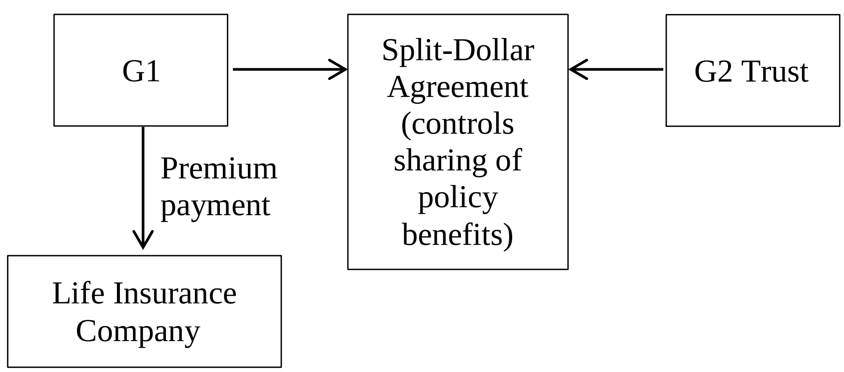
1. Client (“Generation 1” or “G1”) creates a GST Trust (the “G2 Trust”) for G1’s children and grandchildren.

2. G1 and the G2 Trust enter into a split-dollar agreement.

3. The split-dollar agreement provides that G1 will purchase a high cash-value life insurance policy on the lives of G1’s children.

4. If the agreement is terminated, or upon the death(s) of the insured(s), G1 receives the greater of (1) the cash surrender value of the policy or (2) the total premiums paid. The G2 Trust receives any remaining proceeds.

5. This technique is known as an “economic benefit regime” arrangement.



6. If G1 dies prior to the termination of the agreement, G1’s rights under the split-dollar agreement would be included in G1’s estate for estate tax purposes.

7. Some appraisers have opined that the value of these rights may be equal to only 5% of the cash surrender value of the policy (reflecting a discount of 95%) due to the length of time to maturity and the uncertainty of when the policy will pay out.

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8. If G1 does not die within four or five years, then G1 could transfer his or her interest in the agreement (whether by gift or sale), claiming the same 95% discount.

9. If the proponents of this technique are correct, then investing, for example, $50 million in a policy could reduce G1's taxable estate by $47.5 million, resulting in tax savings of between $16.6 million and $26 million.

Potential Pitfalls of Economic Benefit Regime Technique

1. Two potential problems exist with structuring the technique this way.

2. First, under the split-dollar agreement, G1 is obligated to make future gifts of the term component each year until G2 dies. We believe that G1 is deemed to make a large one-time gift equal to the present value of the future expected term premium payments <u>on the date that the split-dollar arrangement is executed</u>.

3. For example, assuming a $50 million investment in an insurance policy where the second generation insured is 45 years old, the gift would be approximately $13.5 million. Using the current gift tax rates and exemptions, the gift tax would be approximately $3 million. Using the gift tax rates and exemptions that are scheduled to take effect on January 1, 2013, the gift tax would be almost $7 million.

4. Second, when using the arrangement discussed above, the IRS Regulations state that either a transfer on death or a sale during life is a transfer of all of the policy, not just the interest in the split-dollar agreement. The value of the policy would be greater than the cash value. As a result, there would be no discount.

5. In summary, there is a $13.5 million taxable gift upfront and over $50 million included upon death.

6. If our analysis is correct, the plan could actually increase the taxable estate by $13.5 million.

The Solution: The Loan Regime Technique

1. Instead of using an economic benefit regime, we use the "loan regime." Under the loan regime, G1 loans cash to the G2 Trust at the applicable federal rate (which is a below-market rate that is acceptable under the Internal Revenue Code).

2. The G2 Trust would then purchase the policy with the loan proceeds. The G2 Trust would be the owner of the policy from inception.

3. Upon G1's later death (or upon the sale of the promissory note received by G1), the promissory note should have a fair market value that is 70% to 90% below its face amount.

4. To avoid the loan being treated as a gift to the G2 Trust, the G2 Trust is required to pay interest to G1 throughout the term of the arrangement. If this is done, then G1 will not be obligated to make any future gifts to the G2 Trust.

5. Under the loan regime, the G2 Trust is treated as the owner of the policy under the IRS Regulations from inception. Therefore, G1 is never deemed to make a transfer of the policy itself, either at G1's death or upon a sale of the promissory note by G1. The below-market loan is transferred instead of the interest in the split-dollar agreement.

6. A $50 million investment in the policy would exclude roughly $35 million from G1's gross estate (based on a 70% discount), saving between $12 million and $19 million in estate taxes.

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678 TRUSTS: PLANNING STRATEGIES AND PITFALLS

By Marvin E. Blum

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. As a result, the client permanently parts with all of the future appreciation, as well as the income stream from the assets. 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.

A 678 Trust can be a useful tool under two fact patterns. The first is when the client is contemplating purchasing an asset or starting a new business venture that has high appreciation or income-generating potential. The second is when the client has significant assets that are already material in value, which the client wants to transfer to the 678 Trust. Structuring the transfer of the assets to the 678 Trust in both fact patterns are discussed in more detail below.

A. 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. **This is the only gift that should ever be made to the Trust**. It is important that the $5,000 contribution to the Trust be a true gift and that the creator of the Trust receive no quid pro quo payments or benefits as a result of making the gift.

The Trust is structured as a "Crummey" Trust, so the beneficiary has a period of time to withdraw the $5,000 gift. If the beneficiary does not demand the gift, his withdrawal right lapses after a certain period of time (e.g., thirty days). In order for the 678 Trust technique to work as intended, it is crucial that the beneficiary not be given a withdrawal right exercisable with regard to any other trust at any earlier point in the year of the gift.

The client is the primary beneficiary of the 678 Trust 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, at inception, the 678 Trust is a separate taxpayer for income tax purposes.

However, the 678 Trust also includes a "Crummey" withdrawal right for the client. When the client allows the withdrawal right over the initial $5,000 contribution to lapse, the 678 Trust becomes a grantor trust as to the client (under the authority of Section 678 of the Code). Thus, all income tax effects of the 678 Trust from that point forward should become the responsibility of the client.

While he is treated as the owner of the Trust for income tax purposes, 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.

B. BENEFITS OF THE 678 TRUST

As discussed above, the assets owned by the 678 Trust will not be subject to estate taxes at the client's death. While the client is living, he or she will continue to have access to the funds for health, education, maintenance, and support purposes and can serve as trustee of the 678 Trust.

In addition, the assets owned by the 678 Trust will not be subject to the claims of the client's creditors. Texas law provides that a Trust that contains "spendthrift" language that is created by a third party will not be subject to the creditors of the Trust beneficiary. This is true even if the Trust is structured as a Crummey Trust and the beneficiary is given a right of withdrawal over the Trust assets. Section 112.035 of the Texas Trust Code specifically states that a Trust beneficiary is not treated as a settlor of a Trust merely because of a lapse of withdrawal rights, provided that the withdrawal right does not exceed the greater of the amount specified in Section 2041(b)(2) or 2514(e) of the Code or Section 2503(b) of the Code (the 5 and 5 rule). As a result, the lapse of a withdrawal right will not cause the Trust assets to be subject to the reach of the beneficiary's creditors. This very clear legislation makes Texas particularly well suited for 678 Trust planning.

Section 112.035 of the Texas Trust Code also provides that a Trust beneficiary is not treated as a settlor of a Trust merely because the beneficiary has the power to consume or distribute Trust property to or for the benefit of himself or herself as long as the power is limited by an ascertainable standard (such as health, education, maintenance, and support). Therefore, a beneficiary's creditors will not be able to reach the Trust's assets if the beneficiary is also named as the trustee, so long as the trustee-beneficiary's distribution standard is limited to health, education, maintenance, and support.

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, 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.

C. 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. Furthermore, with many corporations accumulating significant cash, some predict a surge in merger and acquisition activity. A closely-held business owner who might be presented with an opportunity to sell the business at some point in the future would be an ideal candidate to sell his or her ownership interest to the 678 Trust prior to such a liquidity event (the earlier, the better).

In these cases, it would 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. The assets pledged should equal at least 10% to 20% of the size of the note (the higher, the better). 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 gift to it. With a $5 million lifetime exemption, the client can make a gift of up to $5 million (or $10 million if the client is married) and pay no gift tax. 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 initial $5,000 gift contributed by a third party**. 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 also 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 adjustment clause could help avoid the argument that the client made a gift to the 678 Trust if the sales price were determined to be lower than the asset's fair market value.

In addition, it is advisable to have the asset sold to the 678 Trust professionally appraised. The appraiser should be advised that the value sought should be on the mid-range of the scale of reasonableness. If the appraisal is too aggressive, and results in a value lower than that reasonably determined by the IRS, it is possible that the client will be treated as having made a gift to the Trust equal to the difference between the appraised value and the IRS-determined value. As a result, the appraisal should not be overly aggressive.

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 still 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.

D. 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 (or other third party who makes the gift) 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 children. In addition, the 678 Trust should contain a spendthrift provision, in which case the Trust assets should be protected from the client's creditors. Furthermore, assets in the 678 Trust do not constitute marital property, protecting the assets if a beneficiary of the Trust gets a divorce.

With regard to assets sold to the 678 Trust, the value of the assets owned by the client is 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 (rather than "grantor" trusts) for income tax purposes.

E. 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, it will be prohibited from challenging the transaction later. The gift tax return will be due on April 15 of the year following the year in which the transaction takes place.

F. EXAMPLES

<u>Example #1</u>: 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 existing 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 the 678 Trust and allocating $5,000 of GST exemption to the 678 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: The 678 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 $2.5 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 approximately $15 million.

Step 2: Client contributes the investment assets to a limited partnership (the "LP"). Assuming a 35% valuation discount, the LP interests would be worth approximately $10 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 $5 million worth of LP interests to it. If Client is married, Client's spouse can also make a gift of up to $5 million worth of LP interests to the Grantor Trust. For a transaction this size, a gift of $2 million should suffice. (Note: This step is not necessary if 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% to 20% of the note amount in exchange for a small fee. [The size of the guaranty dictates the amount of LP interests the Client can sell, as the guaranty should be at least 10% to 20% of the note amount (the higher, the better).]

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 $2 million gift to the Grantor Trust and disclosing 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 should be 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 appreciate. At Client's death, if Trust assets are worth $25 million and the estate tax rate is 55%, then Client has saved approximately $8.25 million in estate tax. [Calculated as follows: (i) $25 million less $10 million (the $2 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) 55% tax rate.]

G. DISCUSSION OF STATUTORY AUTHORITY

Although the beneficiary may be deemed to be the grantor of the trust for income tax purposes, he is not considered the grantor for estate and gift tax purposes. Under Section 2041 and Section 2514 of the Code, a lapse of a withdrawal right is not deemed to be a gift to the Trust from the beneficiary so long as the lapse does not exceed the greater of $5,000 or 5% of the Trust assets (the "5 and 5 power"). As a result, allowing the withdrawal right to lapse will not cause the assets of the 678 Trust to be subject to estate taxes at the client's death. (Note that an affirmative <u>release</u> of a withdrawal right may have the opposite effect. If a holder of a withdrawal right releases the right, he or she could be treated as having made a gift to the Trust, causing the Trust assets to be subject to estate taxes at the holder's death. Therefore, in order to clearly qualify for the statutory "5 and 5" exception, the plan is for the beneficiary to allow the withdrawal right to <u>lapse</u>, rather than <u>release</u> it.)

Under Section 678(a)(1), a person who "has a power exercisable solely by himself to vest the corpus or the income" of the Trust in himself will be treated as the owner of the portion of the Trust over which the power is held. A withdrawal right gives the beneficiary the right to vest the corpus or the income of the Trust in himself and, as a result, is a power that will cause the Trust to be owned by the beneficiary for income tax purposes under Section 678(a)(1) so long as the power remains outstanding. If the withdrawal right applies to all of the assets owned by the 678 Trust (as in the case of the initial $5,000 gift), then the entire Trust will be treated as owned by the beneficiary for income tax purposes. Once the withdrawal right lapses, however, the income tax treatment of the Trust is not as clear.

Under Section 678(a)(2), a person who "has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof" will be treated as the owner of the portion of the Trust over which the power was partially released or modified. The question, therefore, is whether the client would be treated as the owner of the Trust under Sections 671 to 677 of the Code if he had been the initial grantor of the Trust.

Under Section 677, the grantor of a trust will be treated as the owner of the trust for income tax purposes if the income of the trust may be distributed to the grantor or held and accumulated for future distribution to the grantor. The client is the beneficiary of the 678 Trust, and as such, income and principal may be distributed to him. Accordingly, if the client releases or otherwise modifies his withdrawal right, then he will be treated as the owner of the Trust for income tax purposes. Based on the plain language of the statute, it appears that this would apply to the entire Trust (both the income and the principal) since the withdrawal right exists over the $5,000 gift, which would comprise the entire Trust at the time the right was granted.

Note that Section 678(a)(2) refers to a "partial release" (as opposed to a "lapse") of a withdrawal right as the triggering event. Although this terminology does not mirror that contained in Sections 2041 and 2514, the IRS has issued a recent private letter ruling interpreting a lapse under Sections 2041 and 2514 to be a partial release under Section 678. PLR 200949012. In addition, the IRS has implied in prior private letter rulings that a lapse under Sections 2041 and 2514 would have the same effect of a partial release under Section 678. *See, e.g.*, PLRs 200747002, 200104005, 200147044, 200022035, 9809005, 8342088.

If the IRS changes its policy expressed in the private letter rulings and argues that a **lapse** is not treated as a **release** under Section 678, it is possible that the client will not be treated as the owner of the Trust for income tax purposes after the withdrawal right lapses. To help mitigate that result, we propose including additional provisions in the 678 Trust.

First, the withdrawal right granted over the initial $5,000 gift to the Trust could extend until at least December 31 of the year in which the gift is made (i.e., the withdrawal right does not lapse until after December 31). Any sales to the 678 Trust should occur before the withdrawal right lapses. During the time that the withdrawal right remains outstanding, the client should clearly be treated as the owner of the Trust for income tax purposes and should be able to transact tax-free with the Trust.

Second, in December of each year, the client could be given a withdrawal right over all of the Trust income earned during that year, to the extent that the income does not exceed the greater of $5,000 or 5% of the Trust assets. (Note that, if the client dies while the withdrawal right is outstanding, the amount of assets over which the withdrawal right exists will be included in the client's taxable estate.) To the extent that the income is less than or equal to this amount, the client should be treated as the owner of the Trust income for income tax purposes. It is not clear whether this withdrawal right would cause the client to be treated as the owner of the Trust's principal for income tax purposes.

If the client is not treated as the owner of the Trust's principal, then the Trust may be required to pay any capital gains taxes out of its own assets. As a result, the tax amount would deplete the assets that will be protected from estate taxes, as opposed to the client's assets, which will be subject to estate taxes. In addition, if the client is not treated as the owner of the Trust's principal, capital gains taxes could be triggered when the Trust makes principal payments on the note owing to the client.

The client and the Trust should also consider entering into an agreement that, if the client pays income taxes and it is later determined that the taxes should have been paid by the Trust, the client will be treated as having loaned the amount paid to the Trust with interest at the applicable federal rate. This should help prevent the client being treated as having made a gift to the Trust by virtue of paying income taxes on the Trust's behalf.

In any case, the client should, at a minimum, be able to sell assets to the 678 Trust while the withdrawal right is outstanding 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 should not be required to recognize the interest payments as income. This characteristic may also cause 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"). The IRS has issued a recent private letter ruling stating that a 678 Trust is a permitted S corporation shareholder under Code Section 1361(c)(2)(A)(i). PLR 201039010. However, it may be advisable to make a protective QSST or ESBT election in the event that the IRS argues that 678(a)(2) does not apply to the Trust assets.

H. TOO GOOD TO BE TRUE?

Some have expressed concern that the 678 Trust technique is "too good to be true." However, it is important to note that, while it can be a particularly effective technique in the right situation, the technique has real economic substance, as it may not always achieve the goal of reducing a client's taxable estate. When assets are sold to a new 678 Trust in exchange for a promissory note, another person or entity must guarantee a portion of the note. In many cases, the guarantor of the note will be an irrevocable trust created by the client and funded with a gift that uses some or all of the client's lifetime gift tax exemption.

If the asset sold to the 678 Trust decreases in value and the Trust is unable to repay the note to the client, the guarantee must be called. In that event, the irrevocable trust must satisfy the guarantee using the assets it received as a gift from the client. As a result, it is possible to do "negative estate planning" if the irrevocable trust is required to use assets it received as a gift to repay the note owing by the 678 Trust to the client. Note that the negative planning would be particularly painful if, as is typical, GST exemption has previously been allocated to the irrevocable trust. As a result, there is a risk of loss associated with this technique, which must be carefully considered when structuring a 678 Trust.