



# Some of the Best Creative Tax Planning Techniques for Trusts

**1.5 General CLE credits**

From the Oregon State Bar CLE seminar *20th Annual Oregon Tax Institute*, presented September 15–18, 2020



# Chapter 1

## Some of the Best Creative Tax Planning Techniques for Trusts©

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## SOME OF THE BEST CREATIVE TAX PLANNING TECHNIQUES FOR TRUSTS©

### I. THE PRIMARY IMPORTANCE OF GOALS-BASED PLANNING FOR THE SUCCESSFUL SUCCESSION OF THE FAMILY WEALTH IRRESPECTIVE OF THE STATUS OF THE TAX LAW.

- A. The Importance of First Determining a Client's Goals That Determine the Estate Plan's Essential Strategies.
  - 1. The prevalence of tax driven wealth preservation focus and four suggested rules to change the priority of that focus.

In assisting a client with achieving their goals the state of the tax law and how that affects the plan should not be the “tail that wags the dog.” Certain tax-planning advisors assume that a combination of wealth preservation and tax reduction is the purpose of every estate and succession plan. All tax advisors from time to time have been guilty of that assumption.<sup>1</sup> Whenever owners and tax advisors gather to formulate a plan, inevitably their conversations focus extensively on tax issues. Something about the topic of tax planning, the prevalence of tax advisory literature, tax advisors' professional degrees and titles, how the meetings originate, and the expectations of the gathered parties combine to dictate this focus.<sup>2</sup>

Tax planner's habitual patterns of engaging in planning conversations that evolve into tax reduction conversations have resulted in the evolution of a conventional style of planning that can be referred to as *tax driven wealth preservation planning*. This planning style begins with advisors gathering relevant facts and recommending optimum legal structures. In most instances, the defining characteristics of the selected strategies and legal structures are their tax reduction and control retention characteristics. A danger in tax driven wealth preservation planning is its subtle power to enable money (and its conservation) to become the defining objective.

Through the years I have developed four personal rules for determining a client's goals and concerns with respect to the family's capital (as defined below): (1) try to ask open ended questions that give the client the opportunity to articulate his or her goals and concerns; (2) listen; (3) listen, and (4) listen.

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<sup>1</sup> I would like to thank Mike Allen of Allen ◊ Lottmann, P.C., in Tyler, Texas. Around 25 years ago Mike articulated these concepts to me. I have been a better advisor since.

<sup>2</sup> L. Paul Hood, Jr., “*From the School of Hard Knocks: Thoughts on the Initial Estate Planning Interview*,” 27 ACTEC Law Journal 297 (2002).

2. Estate plans developed around the stewardship purpose of the family wealth.

It is enlightening to contrast conventional *tax driven wealth preservation plans* with plans which have been formulated for clients who were initially asked (perhaps through the vehicle of many open-ended questions): "What is the purpose (or stewardship mission) of your family wealth?" A family's wealth, or capital, is more than its financial capital. A family's social capital and stewardship capital are also very important and interact with the family's financial capital.

When planning conversations begin with open-ended questions to determine the purpose or mission of the family's capital, a different succession plan may emerge, and the priority of tax reduction can be expected to decline in status from the defining principle to an important collateral objective.

At an introductory stage, a dialogue about purpose or stewardship mission questions might evolve like this:

|             |  |
|-------------|--|
| Question 1: | Do you want to save taxes? Answer: Yes.  |
| Question 2: | Do you want to protect your wealth? Answer: Yes.   |
| Question 3: | Do you want to preserve the same level of consumption? Answer: Yes.  |
| Question 4: | Do you want to empower your children (or favorite charitable causes)?<br>Answer: Yes.  |
| Question 5: | Do you want to give your children (or charitable entities you create) options? Answer: Yes.  |
| Question 6: | Do you want to give your children (or charitable entities you create) incentives? Answer: Yes.   |
| Question 7: | Do you want to maintain control of investment decisions with respect to your wealth? Answer: Yes.  |
| Question 8: | Do you want to maintain your flexibility (control) to change your mind about how and whom should have future stewardship of your wealth?<br>Answer: Yes. |
| Question 9: | Which of these is most important? Typical Answer: (pause) That is the first time we have been asked that question. We'll need to think about it.         |

Members of my tax planning fraternity routinely start with good questions. But we sometimes tend to stop asking them too quickly (often after question 3), and we seldom ask question 9.

Questions of stewardship mission or the purpose of the family wealth are not raised lightly. They are the most important questions in the succession planning process. Their answers should govern every design decision.

3.     Organizational pattern of a purpose-based estate plan:

A hierarchical organizational pattern for a purpose-based estate plan is:

*Purpose*

The declared principles for the family's capital which determine the plan's essential characteristics

(having priority over)

*Strategies*

The alternative game plans for implementing the essential characteristics

(having priority over)

*Legal Structures*

The legal documents which embody and implement the essential characteristics

4.     Compatibility of strategies and legal structures with the stated purpose of family wealth.

When an estate succession plan is organized around declared principles, the strategies and legal structures used to accomplish conventional tax planning are retained, but they are modified as necessary to make them compatible with the declared principles.

B. Once the Purpose and Use of the Family’s Capital Has Been Determined, Trust Planning Strategies Should Be Developed to Maximize the Investment Risk-Adjusted, After-Tax Wealth That May Be Applied to Those Purposes and Uses.

Under current transfer tax laws, almost all of the US population (estimates are over 99.93%) does not have to worry about strategies that reduce transfer taxes.<sup>3</sup> However, according to the Gallup poll on May 24, 2017, 54% of Americans own stocks and presumably would welcome strategies that would lower income taxes on their individual investments and/or trust investments.

Planning almost always begins with the use of trusts. There are trust planning strategies that reduce both the income taxes on capital and its income and the transfer taxes on capital. Trust planning for those two taxes does not have to be, and should not be, an “either or” exercise. The purpose of this paper is to discuss some of the most creative trust planning strategies that reduce both taxes.

This paper is organized to discuss some of the most creative trust planning strategies by discussing non-grantor trusts (the taxable income of the trust is taxed to the trust, except for trust distributions), grantor trusts (the taxable income of the trust is taxed to the grantor), spousal grantor trusts (the taxable income of the trust is taxed to the spouse of the beneficiary), and beneficiary defective owned trusts (the taxable income of the trust is taxed to the beneficiary of the trust).

Sometimes the strategies involve more than one type of trust so the paper begins with a brief discussion of each type of trust.<sup>4</sup>

II. BRIEF INTRODUCTION TO NON-GRANTOR TRUSTS, GRANTOR TRUSTS, SPOUSAL GRANTOR TRUSTS AND BENEFICIARY DEEMED OWNED TRUSTS.

A. Non-Grantor Trusts (*See* a more thorough discussion *infra* Section III).

Non-grantor trusts are treated as separate taxpayers. Non-grantor trusts are currently taxed in 2020 at the highest rate when the taxable income exceeds \$12,950. However, non-grantor trusts enjoy deductions from taxable income for amounts required to be distributed to the trust beneficiaries or are properly paid or credited to them. *See* IRC Sections 651 and 661. A corresponding amount of income is included in the gross income of the beneficiaries. *See* IRC Sections 652 or 662. With respect to charitable beneficiaries of a non-grantor trust, the

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<sup>3</sup> The Joint Committee on Taxation estimates that in 2018 only 1,800 of the estimated 2.6 million decedents will have to pay estate taxes.

<sup>4</sup> I would like to thank some of my colleagues at Goldman Sachs who helped with many of the ideas expressed in this paper: Jeff Daly, Cliff Schlesinger, Kary Dye, Chi-Yu Liang, Andrew Haave and Cathy Bell. Many of the ideas generated in this paper also came from the fertile minds of my attorney friends, including: Carlyn McCaffrey, Austin Bramwell, Ed Marrow, Ellen Harrison, David Handler, Jonathan Blattmachr, Richard Dees, Mickey R. Davis, Melissa J. Willms, Turney Berry, Ivan Taback, Steve Gorin, Eric Fischer and Dan T. Hastings.

non-grantor trust can receive a deduction for amounts of gross income paid for charitable purposes. *See* IRC Section 642(c).

B. Grantor Trusts (*See* a more thorough discussion *infra* Section IV).

The grantor of a trust may be treated as the deemed owner for income tax purposes of all or a portion of the trust if certain provisions exist in the trust document. *See* IRC Sections 671-677 and 679. These provisions may not cause the trust assets to be included in the grantor's estate for estate tax purposes. For instance, the following provisions may cause the grantor to be the deemed owner for income tax purposes of all or a portion of the trust, but do not cause the trust assets to be included in the grantor's estate for estate tax purposes: the retained power by the grantor or another non-adverse party to substitute property of equivalent value; trust allows a non-adverse party to make fair market loans to the grantor or the grantor's spouse without adequate security; the trust provides that income or corpus could be distributed to the grantor's spouse; the trust provides that a person has the power to expand the class of beneficiaries; the grantor's spouse is a trustee of a trust in which the trustee has the power to make discretionary distributions of income or principal; a related or subordinate person to the grantor is trustee who may make distributions among a class of beneficiaries; and the trustee has authority to acquire to pay life insurance premiums from income of the trust on the life of the grantor or the grantor's spouse and does so. The IRS has conceded that the payment of income taxes on the income of a grantor trust is not a gift to the trust beneficiaries. *See* Rev. Rul. 2004-64.

C. Spousal Grantor Trusts (*See* a more thorough discussion *infra* Section V).

A spousal grantor trust is a trust in which the deemed income tax owner is the spouse of the beneficiary. A transaction between the beneficiary of the spousal grantor trust and the spousal grantor trust is treated as a transaction between the beneficiary and his or her spouse. A transfer between spouses is treated as a non-recognition event for income tax purposes. *See* IRC Section 1041. The beneficiary spouse could sell assets to the spousal grantor trust without any capital gains consequences. Any assets the beneficiary spouse sells for adequate and full consideration will not be included in the spousal beneficiary's estate. The spousal grantor trust could be designed to allow the beneficiary's spouse to modify the remainder provisions through a special power of appointment. *See* IRC Sections 2036, 2038 and 2041.

D. Beneficiary Defective Owned Trusts (*See* *infra* Section VI for a more thorough discussion).

Beneficiary defective owned trusts are trusts in which the deemed owner of the trust assets for income tax purposes is the beneficiary of the trust because IRC Section 678 applies. There are three methods where IRC Section 678 can apply to a trust. In each of these methods the trust cannot have provisions that would make the trust a grantor trust. *See* IRC Section 678(b).

1.     IRC Section 678(a)(1) application. (*See* a more thorough discussion *infra* Section VI.A.).

A beneficiary is the deemed income tax owner of any portion of a trust in which the beneficiary has a power “exercisable solely by himself to vest corpus or income of that portion in himself, herself or itself.” If an individual has the power to vest only the taxable income of the trust, IRC Section 2041 may not apply. If the withdrawal beneficiary sells assets to the trust for adequate and full consideration those assets will not be included in the withdrawal beneficiary’s estate. *See* IRC Sections 2036, 2038 and 2041. For purposes of this paper, these trusts will be referred to as “beneficiary defective owned trusts” or “BDOTs.”

2.     IRC Section 678(a)(2) application. (*See* a more thorough discussion *infra* Section VI.B.).

A beneficiary is the deemed income tax owner of any portion of a trust in which that person has “previously partially released or otherwise modified” an IRC Section 678(a)(1) vesting power and retains control that would cause the grantor to be treated as the trust owner. For purposes of this paper, these trusts will be referred to as “beneficiary defective inheritor’s trusts” or “BDITs.”

3.     IRC Section 678 application because of operation of IRC Section 1361(d)(3). (*See* a more thorough discussion *infra* Section VI.C.).

With respect to stock of a subchapter S corporation owned by a trust, if the requirements of IRC Section 1361(d)(3) are met, the income beneficiary of a trust that holds subchapter S stock will be considered the deemed income tax owner of that subchapter S stock. Such a trust will be referred to as a qualified subchapter S trust or a “QSST.”

### III.    SOME OF THE BEST CREATIVE TAX PLANNING IDEAS FOR NON-GRANTOR TRUSTS.

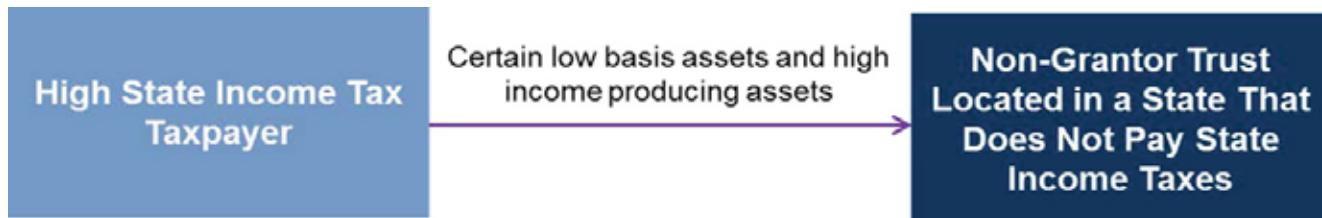
#### A.     Using Non-Grantor Trusts to Reduce State Income Taxes and to Reduce or Avoid Certain Federal Income Taxes.

While the top bracket for non-grantor trusts starts at a relatively low level (approximately \$13,000 in 2020), there are circumstances in which non-grantor trust can save income taxes because that non-grantor trust may have deductions available to it that the beneficiaries of the non-grantor trust may not have available. Gifts and loans to a non-grantor trust can be a great estate planning tool, if the assets of the non-grantor trust grow above any interest carry that may exist. Under the circumstances noted below, a non-grantor trust can also be an income tax savings tool.

Obviously, some states have much higher income tax rates than other states. Eight states do not have any state income taxes. Several more states do not subject income accumulated in non-grantor trusts that are created in those states to their state income taxes. The problem of high state income taxes could be particularly acute, if the taxpayer anticipates that sometime in the future he may sell some valuable low basis assets.

1. The technique.

A taxpayer who lives in a high income tax state may have low basis assets that he anticipates may be sold in the near future. That taxpayer may also have income producing securities from which he does not need that income for his consumption needs. That taxpayer could transfer those assets to a non-grantor trust whose situs is in a state that does not have any state income taxes on the income earned and accumulated by those trust assets. See a diagram of the technique below:



2. Advantages of the technique.

- a. Substantial state income taxes could be saved.
- b. The taxpayer using his or her increased gift tax exemptions could create a non-grantor trust in a state that does not tax that trust income, which could save income taxes and transfer taxes.
- c. A non-grantor trust used for these purposes could be created without paying gift taxes: by the use of the taxpayer's exemption; by creating a trust that is incomplete for gift tax purposes; or by creating a marital deduction trust that qualifies as a QTIP trust and is designed to be a non-grantor trust with respect to the principal earnings of the QTIP trust.
- d. There could be multiple non-grantor trusts, subject to the discussion of certain considerations *infra* Section III.A.3.

3. The IRC Section 643(f) considerations of the technique.

IRC Section 643(f) provides that two or more trusts that have substantially the same primary beneficiaries or beneficiaries, and a principal purpose of such trusts is the avoidance of income tax, the trusts will be treated as one trust. The final regulations backed off of the proposition that just because the trusts save income taxes it does not necessarily mean the principal purpose of such trusts is avoidance of income taxes.

4. Non-grantor trusts may have the ability to increase IRC Section 199A deduction thresholds.
  - a. What is an IRC Section 199A deduction and how does it work?
    - (1) What is it?

(a) New deduction for domestic qualified business income (“QBI”) as part of the Tax Cuts and Jobs Act of 2017 (“TCJA”) signed into law December 22, 2017.

- (2) How much is it worth?

At most, the deduction could be up to 20% of QBI (i.e. could make 37% ordinary rate effectively 29.6%).

- (a) A taxpayer’s IRC Section 199A deduction is the lesser of (i) taxpayer’s “combined qualified business income amount,” or
- (b) Twenty percent of the excess, if any, of the taxpayer’s taxable income for taxable year less the taxpayer’s net capital gain. For this purpose, “net capital gain” includes qualified dividends.
- (3) Combined QBI amount is the sum of (i) deductible amount for each qualified trade or business carried on by the taxpayer, plus (ii) 20% of qualified REIT dividends and 20% of qualified publicly traded partnership income.
- (4) Who gets the new deduction?

Individuals, trusts and estates that are reported QBI from partnerships, LLCs, S corporations, sole proprietorships, rental properties, or farm operations.

- (5) Are there limitations for taxpayers who have marginal taxable income above certain taxable “income threshold amounts?”
  - (a) Yes, the maximum deduction is 20% of QBI, however, the deduction amount allowed may be further limited depending on several factors:
    - (i) W-2 wages – limited to 50% of wages, or
    - (ii) W-2 wages and qualified property – limited to 25% of wages plus 2.5% of unadjusted

basis immediately after acquisition (UBIA) of qualified property; however, under the final regulations, additional basis may be allowed from certain step-up transactions and the allowance of basis from certain carryover transactions.

(iii) Does the business even qualify? There is no deduction for taxable income allocated from specified services trades or businesses (“SSTB”) for owners whose marginal income tax bracket is above 32%. For 2019, the taxable income “threshold amount” is \$326,600 for married filing jointly and \$163,300 for all others (including trusts). That threshold amount is inflation indexed for future years.

(6) How long is the deduction available?

The deduction became available in tax years starting 2018; this provision of the law sunsets after 2025.

(7) The IRC Section 199A deduction does not apply to:

- (a) Investment income.
- (b) Foreign source income.
- (c) Wages paid to shareholders.
- (d) Guaranteed payments for the use of capital.
- (e) Capital gain from the sale of business assets.

(8) Uncertainty related to “trade or business” definition remains.

- (a) Taxpayers must analyze facts and circumstances to determine whether activities rise to the level of a trade or business.

(9) All computations and determinations under IRC Section 199A are made at the trade or business level – not at the entity level.

(10) Whether a taxpayer is conducting one business, or several businesses, can dramatically impact qualification for the deduction and complexity of reporting items related to it.

(11) There is a de minimis “cliff” of specified service activity within a trade or business.

(a) The IRS confirmed in the preamble to the final regulations its belief that the statute indicates that any amount of specified service activity will render the entire business a SSTB:

“...the word ‘involving’ suggests that any amount of specified service activity causes a trade or business to be an SSTB.”

(b) However, an otherwise qualified trade or business will not be a SSTB if:

(i) Less than 5% of its gross receipts are attributable to the performance of service in a field that would normally be considered an SSTB; or

(ii) Less than 10% of its gross receipts are so attributable if gross receipts are  $< \$25,000,000$  for the taxable year.

(iii) Cliff effect still applies if a trade or business exceeds the de minimis threshold.

(12) Aggregation.

(a) Aggregating businesses.

(i) Taxpayers may carry on multiple, related trades or businesses that would otherwise be limited if viewed independently.

(ii) The regulations provide a mechanism to aggregate businesses, if certain tests are met.

(b) Taxpayers can generally aggregate if:

(i) The same person, or group of persons, directly or indirectly owns a majority

interest (at least 50%) in each of the distinct trades or businesses for a majority of the taxable year.

(ii) None of the aggregated trades or businesses are SSTBs.

(iii) The aggregated trades or businesses share the same taxable year.

(iv) The trades or businesses to be aggregated satisfy at least two of the following three factors:

- The trades or businesses provide products and/or services that either are the same or are customarily provided together.

- The trades or businesses share facilities or share significant centralized business elements (accounting, legal, purchasing, HR, IT, manufacturing, etc.).

- The trades or businesses are operated in coordination with or are reliant upon other businesses in the aggregated group.

(13) The final regulations provide that if the percentage of SSTB gross receipts are above 10% of the business' gross receipts (if the total business gross receipts are less than \$25,000,000) then the whole business is treated as a SSTB, unless further steps are taken by that business. If the total business gross receipts are above \$25,000,000 and if the percentage of SSTB gross receipts are above 5% of the total business gross receipts then the whole business is treated as a SSTB, unless further steps are taken.

(14) Also, many businesses have substantial revenues that are SSTB, but part of their business is non-SSTB. For instance, some accounting firms provide billing, administrative and management services. Another example, many law firms provide trustee, executor, title insurance, clerk and closing services, stenography services

and delivery services, all of which may not constitute the practice of law.

(15) For businesses that have substantial SSTB income and for businesses that may not qualify under the above-noted “de minimis exception” the following steps should be taken for the cautious taxpayer:

- (a) Separate books and records should be kept for the non-SSTB business and the SSTB businesses.
- (b) There should be different LLCs or other entities to house the SSTB activities and the non-SSTB activities.
- (c) The different entities should have different employees.

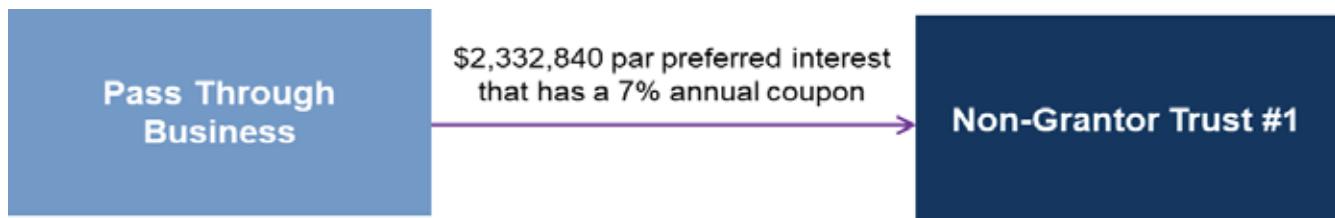
b. As noted above, if the non-grantor trust income is below a threshold amount the trust is not subject to wage or the unadjusted basis limitations on the amount of the deduction.

- (1) For instance, taxpayers below the threshold amount are permitted a deduction for income from even specified service businesses.
- (2) Under final regulations a distribution can carry out the business income (which includes service business income) to the beneficiary.
- (3) Consider using the combination of multiple non-grantor trusts and preferred interests in pass through businesses, to save federal income taxes by using the deduction under IRC Section 199A, which otherwise would not be available.
  - (a) Below is an example of the technique.

If a non-grantor trust has an interest in a pass through business and has an amount of taxable income below the 32% bracket (which in 2020 is \$163,300) that non-grantor trust will receive a 20% deduction on the amount of the qualified business income (“QBI”) allocated to the trust. This is true, even if the income comes from a service business that would not otherwise qualify as qualified business income, the income is subject to the W-2 wages limit under IRC Section 199A(b)(2)(B)(i), or the income is subject to the W-2 wages and property limit under IRC Section 199A(b)(2)(B)(ii).

In order to manage the amount of QBI and other taxable income allocated to the non-grantor trust in future years, the non-grantor trust's interest in the income tax pass through business could be a preferred interest with the coupon being equal to \$163,300 in the first year with an increase each year in the par value of the preferred interest equal to the inflation adjustment that determines the 32% bracket. For example, a business owner of a pass through business gifts to a non-grantor trust a preferred interest in his pass through business that has a par value of \$2,332,840 that pays a 7% coupon on that par value or \$163,299. The par value of the preferred interest could be designed to increase at the same percentage rate as the 32% bracket increases. The coupon cannot be a guaranteed payment because that would be treated like salary income under IRC Section 199A. A tool to keep the taxable income at that \$163,299 threshold amount is for the trustee to invest in assets, other than its business interest, that do not produce any, or very little, taxable income (e.g., municipal bonds or non-dividend paying stocks). If a non-grantor trust's taxable income before the QBI deduction is between \$163,300 and \$207,350, that estate or trust will be subject to the phase in limit rules of IRC Section 199A(b)(3)(B) and the phase-out rules for specified service trades or businesses contained in IRC Section 199A(d)(3).

Please see the diagram of the example below:



(b) Advantages of the technique.

- (i) The technique lowers the family's income taxes associated with the family business.
- (ii) There could be multiple non-grantor trusts, subject to the IRC Section 643(f) consideration *infra* Section III.A.3.
- (iii) For many families there should not be any gift taxes associated with the gifts to the non-grantor trusts, either because of the increased exemption, or because the non-grantor trusts are designed to be an incomplete gift (a so-called "ING trust," *see* the discussion *infra* Section III.F.).
- (iv) Because of Revenue Ruling 83-120, if a preferred interest is used, the yield can be relatively high in comparison to the then

prevailing interest rates, without causing gift tax consequences. *See* the discussion *infra* Sections III.E.3.c.

(c) Considerations.

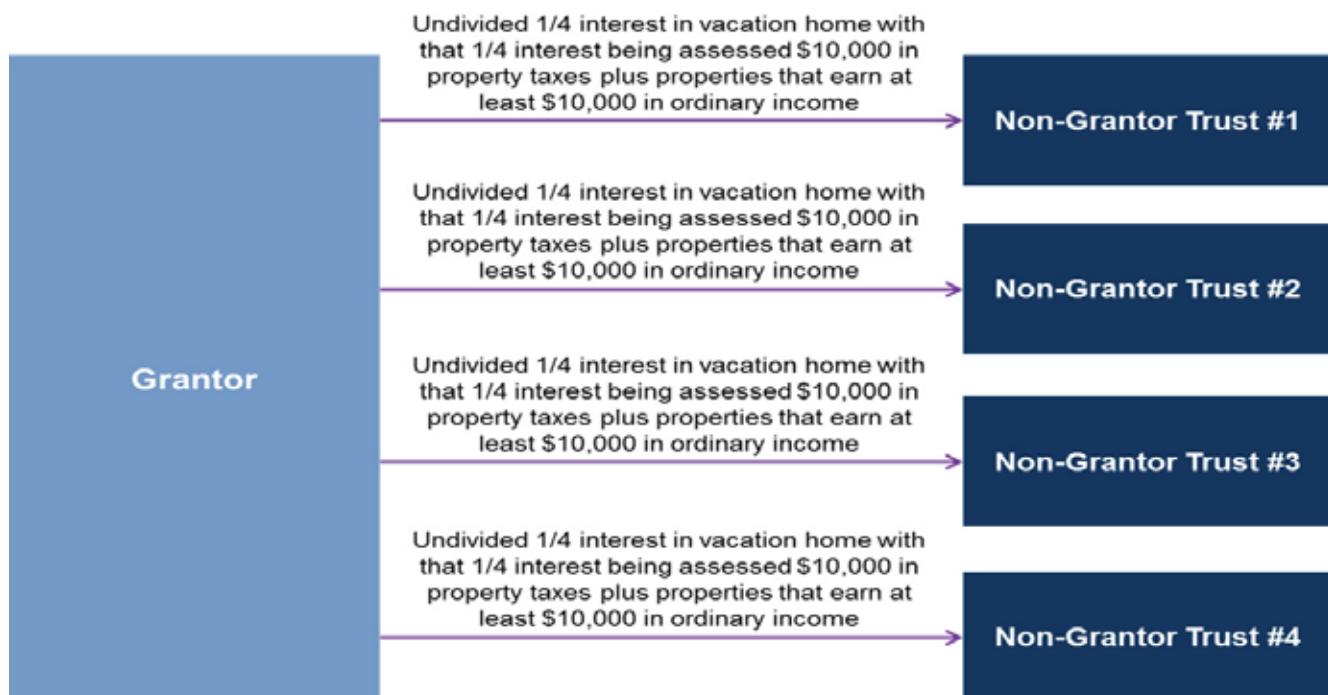
In addition to the IRC 643(f) considerations (*see* the discussion *supra* Section III.A.3) the regulations under IRC Section 199A provide an anti-abuse rule that a trust, if it is formed with a purpose of avoiding the threshold amount or of using more than one threshold amount, the trust will not be respected as a separate entity for purposes of determining the threshold amount. Other purposes must be found.

5. Non-grantor trusts may have the ability to mitigate the SALT limitation. For income tax years 2018 to 2025, the aggregate amount of state and local real property taxes, personal property taxes, and state and local income taxes may not exceed \$10,000 or \$5,000 in the case of a married person filing separately.

- a. The technique.

An owner of real estate may split his or her ownership of the real estate into multiple undivided interests and contribute each of those undivided interests, along with ordinary income producing property that is designed to earn at least \$10,000, to different non-grantor trusts assuming each of those non-grantor trusts has at least \$10,000 of ordinary income the \$10,000 capped deduction for property taxes can be used for each new non-grantor trust.

Please see an example of the technique below:



b. Advantages of the technique.

This technique has the same advantages as using non-grantor trusts to save state income taxes. *See* discussion *supra* Section III.B. In addition, for many taxpayers, the complexity of creating an ING trust may not be necessary. The object of this technique is to save federal income taxes, not state income taxes. Assuming the taxable income of the trusts is around \$10,000, the state income tax issues should be insignificant.

c. Considerations of the technique.

*See* the discussion of IRC Section 643(f) consideration *supra* Section III.A.3.

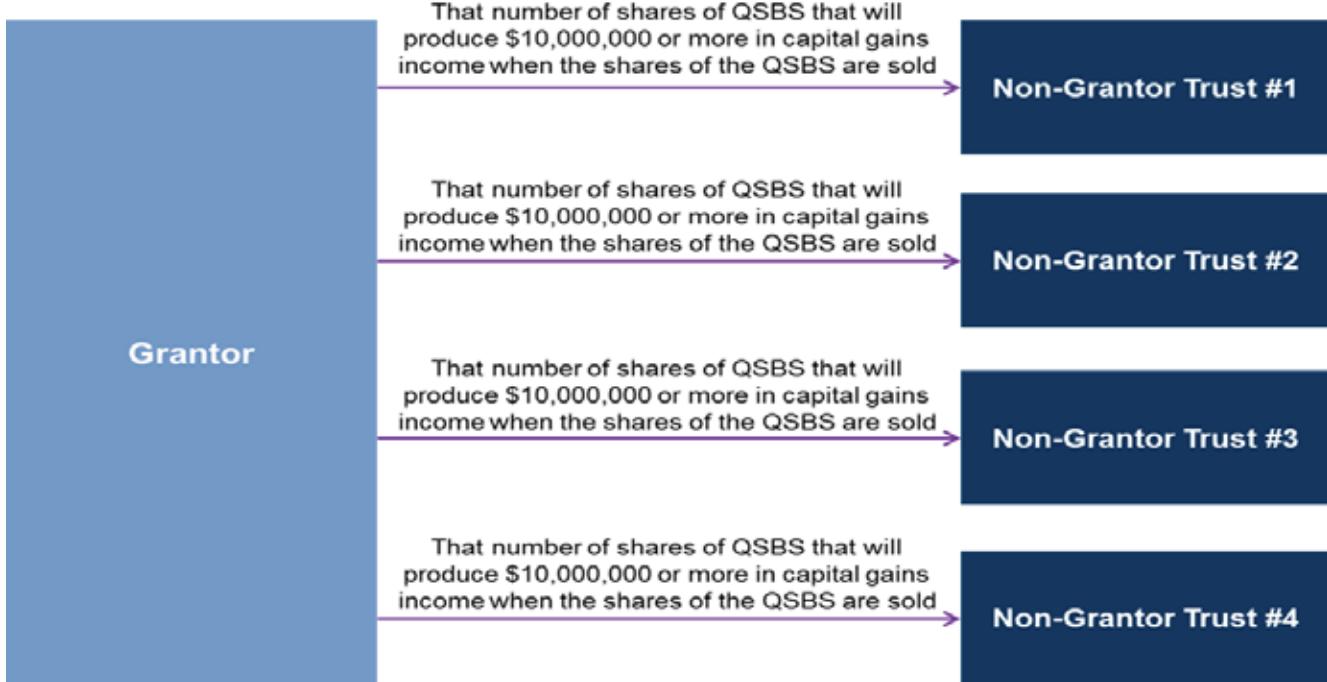
6. Non-grantor trusts could expand the sale of qualified small business stock (QSBS) from capital gains treatment.

a. The technique.

An owner of shares of QSBS, as defined in IRC Section 1202(c), could give shares of his QSBS stock to multiple non-grantor trusts in order to receive multiple \$10,000,000 deductions under IRC Section 1202(b)(1)(A) from the capital gains tax for the collective sale of that stock. If a C corporation meets the requirements of being QSBS and is held for more than five years, all of the inherent capital gains will be excluded subject to the greater of two statutory limits. One of those limits is 10 times the adjusted basis of the QSBS issued by such corporation and disposed of by the taxpayer during the taxable year. With respect to this limit the adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which such stock was originally issued. *See* IRC Section 1202(b)(1)(B). For many owners of shares in a QSBS this limitation may be significant because of the modest basis a start-up business may have.

However, the other limit found in IRC Section 1202(b)(1)(A) in many circumstances is much more generous. This limitation is equal to \$10,000,000, regardless of the taxpayer's basis in the QSBS stock, reduced by the aggregate amount of eligible gain taken into account by the taxpayer for prior taxable years and attributable to dispositions of stock issued by the corporation.

Please see an example of the technique below:



b. Additional advantages of the technique.

This technique has the same advantages as using non-grantor trusts to save state income taxes. *See* discussion *infra* Section III.B.

c. Considerations of the technique.

*See* the discussion of the IRC Section 643(f) consideration *supra* Section III.A.3.

- (1) IRC Section 1202(h)(2)(A) applies to property transferred “by gift.” No case or ruling considers whether this requires a completed gift for gift tax purposes.
  - (a) If it does, then the transfer to the non-grantor trust may incur gift tax (or use gift tax exemption).
  - (b) If it does not, then a transfer to an “ING” trust, a non-grantor trust that is not a completed gift, may qualify. See III.F. below.
  - (c) Because IRC Section 1202 is an income tax provision, arguably a completed gift for gift tax purposes is not required.

B. Non-Grantor Trust Beneficiaries, Who Live in a State with a High State Income Tax, Can Have the Beneficial Use of the Non-Grantor Trust Assets and May Avoid or Reduce Income Taxes Associated with That Use.

1. Tax-free benefits to beneficiaries in high tax states.
  - a. Non-grantor trusts can be designed to not be subject to state income taxes of a high tax state if the resident trust requirements of the high tax state do not apply.
    - (1) The rules determining which state (or states) will assert jurisdiction to tax a trust's undistributed income are complex and vary from state to state. More than one state may assert the right to tax all or part of such income.
    - (2) One or more of the residence of the trust creator, the residence of the beneficiaries, the residence of the trustees, the location of trust assets, the source of trust income and the trust's principal place of administration may be predicates for taxation.
    - (3) A state's general rule may have exceptions, and exceptions to the exceptions. For example, in general a trust created by a New York resident or decedent is subject to New York income tax. There is an exception for a trust with no New York trustees and no assets located in or income sourced to New York. There is an exception to the exception for a trust that is an "ING" trust, a non-grantor trust that is an incomplete gift for federal purposes, which is treated as a grantor trust for New York purposes.
    - (4) In *North Carolina v. Kaestner Family Trust*<sup>5</sup>, the U.S. Supreme Court held unconstitutional a North Carolina statute taxing undistributed trust income solely on the basis of a beneficiary's residence in North Carolina.
  - b. There are circumstances in which non-grantor trust beneficiaries, who live in a high tax state, can receive tax free benefits of that trust located in a low tax state.

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<sup>5</sup> 588 U.S. \_\_\_ (2019),

- (1) The trustee might give beneficiaries the free use of trust assets such as a residence.<sup>6</sup>
- (2) The trustee could make loans to the beneficiaries on very favorable terms.
  - (a) The beneficiary could invest the proceeds of the loan in assets that could produce investment income to pay any interest (if there is interest) on that loan. If the beneficiary's investment income is not high enough to deduct the interest the trust could distribute cash which would carry out the amount of investment income that would allow the beneficiary to deduct the interest. That trust distribution could be made up to 65 days after the tax year in which the interest payments are made, provided a timely election is made under IRC Section 663(b).
  - (b) A consideration of the loan technique is that the IRS could take the view that the loan is a tax avoidance loan, if the IRS finds the principal purpose of the loan is to save income taxes. However, the trustee may have non-tax reasons for making the loan.
- (3) The technique of distributing low basis property intended for sale in the near term from a low tax state trust to the high tax state beneficiary in a manner whereby the beneficiary could sell the distributed property without paying any state and federal taxes.
  - (a) IRC Section 643(e)(3) allows a trustee to elect to recognize gain on the distribution of property to the beneficiary.
  - (b) The distribution of property may carry out trust income to the beneficiary, if that distribution carries out D.N.I. The election may increase the DNI carried out to the beneficiary because the fair market value of the distributed property, rather than its basis, will be used for purposes of

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<sup>6</sup> See *Plant v. Comm'r*, 30 BTA 133 (1934) acq. 1976-1 CB1 aff'd.; 76 F2d 8 (2nd Cir. 1935); PLR 8341005.

determining the amount distributed. However, if capital gains are not otherwise included in the trust's DNI, the gain recognized by the trust on the distribution may not itself be included in the trust's DNI, thereby giving the beneficiary in a high tax state increased basis without subjecting the gain to state tax at the beneficiary's rate.<sup>7</sup>

- (4) The low tax state non-grantor trust could contribute its assets to a subchapter S corporation and make distributions to beneficiaries who reside in certain high tax states on a tax free basis.
  - (a) The trustee of the low tax state non-grantor trust could contribute assets to a subchapter S corporation and make an election to be taxed as an Electing Small Business Trust ("ESBT"). *See* IRC Section 1361(c)(2)(A)(v).

If a trust is an ESBT and owns only the subchapter S corporation, trust income is excluded from D.N.I. and is taxed at the highest federal rates without a distribution deduction regardless of distributions actually made. *See* IRC Section 641(c)(1)-(2); Treasury Regulations Section 1.641(c)-1(i). Thus, any distributions from the ESBT to beneficiaries who reside in a high tax state will be received income tax free, if the beneficiary's state follows the ESBT rules. Income taxed to the trust will be subject to state tax at the rate of the low tax state. If the ESBT owns assets outside the subchapter S corporation, it is treated for income tax purposes as two separate trusts, and the rules stated in this paragraph apply separately to the S portion of the trust.

Additionally, the subchapter S corporation may be able to deduct investment management fees if the deduction is a trade or other business expense. Whether an investment management fee is a trade or business expense of the subchapter S corporation is a complex subject and is beyond the scope of this paper.

- (b) A consideration of the technique is that the highest federal tax rate applies on ordinary income, but the ESBT will have the benefit of lower capital gains rates on realized capital gains and qualified dividend income. Another consideration is that not all states follow the federal ESBT rules in all circumstances.

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<sup>7</sup> *See* Treasury Regulations Section 1.643-3(a) and (b) (providing that capital gains generally are not included in DNI unless they are allocated to income, allocated to corpus but treated consistently by the fiduciary as part of a distribution to a beneficiary or allocated to corpus but actually distributed to the beneficiary).

(5) Non-grantor trust income in a low tax state could be trapped by making distributions to another trust before it is distributed to a beneficiary who lives in a high tax state.

Assume a discretionary trust has the power to make distributions to not only a beneficiary but also a trust for a beneficiary. Assume in year 1 the discretionary trust, located in a low tax state (“Trust 1”), allocates its income to a trust, which is also located in a low tax state (“Trust 2”), for a beneficiary. Trust 2 will pay income tax on that distributed income. In year two, at the beginning of the year, the assets in Trust 2 could be distributed to the beneficiary who resides in the high tax state. The high tax state beneficiary will only pay income tax on the income earned by Trust 2 in year two.

C. Taxing a Non-Grantor Trust at the Beneficiary’s Low Individual Income Tax Rate Without Making Distributions, on a net basis, to the Beneficiary.

1. The technique (*also see* the discussion of subchapter S corporations and qualified subchapter S trusts (“QSSTs”) *infra* Section VI.F.).

Many trust documents creating non-grantor complex trusts provide that if any investment is made in a subchapter S corporation that part of the trust will convert into a QSST. Or, in appropriate circumstances, a complex trust could be modified by court order to be a QSST for that part of the trust that will own a subchapter S investment. In order to ameliorate fiduciary concerns about following the trust grantor’s intent, assume the amount of distributions to the QSST beneficiary is taken into account by the trustee in determining the amount of the distributions, if any, to the beneficiary out of the assets of the complex trust that are not held in the QSST. It is assumed the beneficiary will not have a limited power of appointment over the QSST.

Under IRC Section 678(a) the trust is ignored for income tax purposes, at least with respect to any subchapter S stock that is held in the trust. The IRS confirmed this grantor trust treatment of subchapter S stock owned by a QSST as to the beneficiary of the QSST in Revenue Ruling 92-84.<sup>8</sup> The key holdings of that Revenue Ruling are as follows:

“Section 1361(d)(1)(B) of the Code provides that, for purposes of section 678(a), which sets forth the rules for when a person other than the grantor will be treated as a substantial owner, the beneficiary of a QSST shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under section 1361(d)(2) is made...”

A has made the election under section 1361(d)(2) of the Code with respect to TR and M corporation. Therefore, under section 1361(d)(1)(B), A is treated as the owner of that portion of TR that consists of stock in corporation M for purposes of section 678(a)....”

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<sup>8</sup> See Rev. Rul. 92-84, 1992-2 C.B. 216.

Section 678(a) is within subpart E of subchapter J of the Code. Therefore, the provisions of section 671 are applicable to the stock of an S corporation with respect to which the beneficiary has made an election under section 1361(d)(2).

Section 1.671-2(b) of the Income Tax Regulations provides that when it is stated in the regulations under subpart E that ‘income’ is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes.

Section 1.671-2(c) of the regulations provides that an item of income, deduction, or credit included in computing the taxable income and credits of a grantor or another person under section 671 is treated as if it had been received or paid directly by the grantor or other person (whether or not an individual).

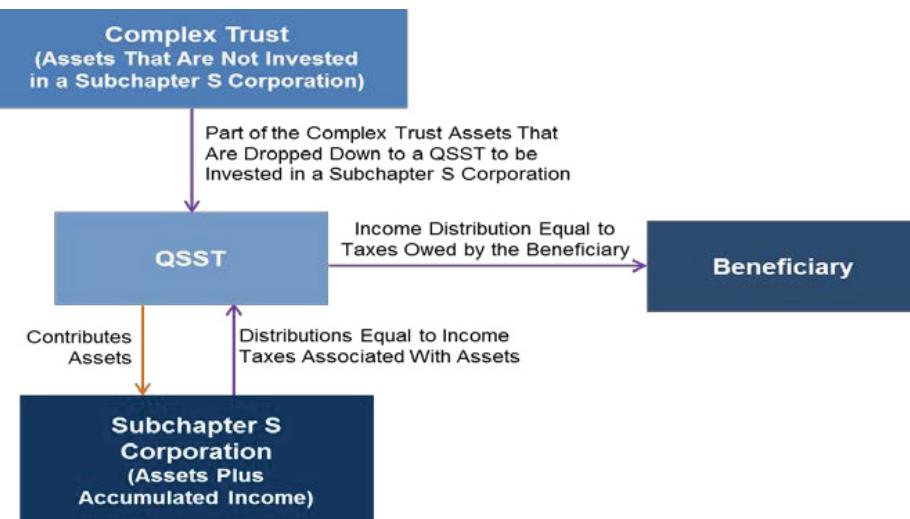
Section 1.671-3(a)(2) of the regulations provides that, if the portion treated as owned by a grantor trust or another person consists of specific trust property and its income, all items directly related to that property are attributable to that portion.

Accordingly, where a grantor or another person is treated as the owner of property constituting corpus under subpart E, the trust is disregarded as a separate entity and any gain or loss on the sale of such corpus is treated as gain or loss of such person,

It should be noted that the IRS revoked Rev. Rul. 92-84, because of cash problems caused by installment sales of subchapter S stock by a QSST when it modified Treas. Reg. § 1.1361-1(j)(8) in TD 8600 (7/20/1995). However, it would seem the other grantor trust aspects of the Revenue Ruling remain, which are consistent with Section 1361 (i.e., for income tax purposes, the beneficiary of the QSST is treated as the income tax owner of any subchapter S stock in the QSST and the beneficiary pays all of the income taxes on the subchapter S income earned by the trust). It should also be noted that the trust assets other than the subchapter S stock will be taxed under the normal subchapter J rules.

After the trustee converts part of the trust assets to QSST, the trustee could manage the QSST in a manner which duplicates the result of a complex trust with lower income taxes. For instance, the trustee could only distribute that amount of cash from the trust owned subchapter S stock that is necessary for the beneficiary to pay his income taxes.

The technique is illustrated as follows:



## 2. Income tax and basis enhancing advantages of the technique.

If only an amount equal to the income taxes the beneficiary must pay is distributed by the S corporation to the QSST, on a net basis, the beneficiary will not receive any cash that could be spent, bequeathed or transferred in a manner the grantor of the complex trust did not intend.

The beneficiary may be in a lower tax bracket than the trust. The beneficiary may be in a lower tax bracket than the trust and is taxed on the taxable income allocated to the QSST. The taxes associated with the beneficiary being the deemed owner of the QSST may equal the cash distributed by the QSST to the beneficiary, which will limit any cash build up in the beneficiary's estate.

There is not any concern about the effect of any lapse of withdrawal rights. Unlike the income withdrawal trust, or as it is sometimes known, the BDOT, or certain other Section 678 beneficiary grantor trust techniques (such as the BDIT), there is no need for the beneficiary of the QSST to have withdrawal rights, because there is no attempt to make all of the assets taxed as a Section 678 trust (only the subchapter S stock owned by the trust). The transfer tax, income tax considerations and creditor protection considerations that may accrue from the existence of a withdrawal right, and from its lapse, are not present in this technique.

If the subchapter S corporation participates in a trade or business, and if the current beneficiary of the QSST materially participates in that trade or business, or is in a lower marginal bracket, significant taxes under Section 1411 may be saved with the technique. The net investment income, as noted above, is not allocated to the QSST, but is allocated to the beneficiary of the trust under Section 678. Thus, if the beneficiary materially, or significantly, participates in the business of the subchapter S corporation there is not any tax. Secondly, even if the beneficiary does not participate, the beneficiary may be in a lower bracket than the trust.

The beneficiary of the QSST will have access to the accounting income distributed to the trust. The beneficiary is the sole income beneficiary of the trust. The distributions could be adequate to pay the beneficiary's income taxes associated with the QSST.

The trust is much more flexible than a simple income only trust and may be administered to simulate a complex trust without the income tax and health care tax disadvantages of a complex trust. The beneficiary is entitled to receive the distributions paid on the subchapter S stock held in the trust, as an income beneficiary. However, the beneficiary pays income taxes (and health care taxes) on all of the income associated with the subchapter S stock owed by the QSST. Much of the income earned by the subchapter S corporation could be retained by the corporation, and the trust and the subchapter S corporation could be managed to simulate a complex trust that does not pay income taxes, which only distributes that amount of cash necessary so that the beneficiary may pay his income taxes on the income earned by that trust.

3. The Transfer Tax Advantage of This Technique is That It Preserves Whatever Inherent Transfer Tax Advantage the Trust Has Without Distributing Net Cash Assets from the Trust to Beneficiaries.
4. Considerations of the technique.
  - a. The federal income tax considerations with utilizing a subchapter S corporation.

To the extent subchapter S stock has not been transferred, and is included in a decedent's estate, the step-up in basis of a decedent's ownership of the subchapter S stock will not be proportionately allocated to the subchapter S corporation's low basis assets as would be the case if the decedent owned a partnership interest and a Section 754 election were made. However, in some cases, this disadvantage may only be one of timing. For instance, assume in the same year, after the death of the owner of the subchapter S stock, the subchapter S corporation sells some of its low basis assets for cash in a transaction that generates capital gain. The corporation may use that cash to redeem the subchapter S stock. The estate will be allocated its share of the gain on that subchapter S corporation sale, which will further increase the estate's basis in its subchapter S shares. That redemption will generate a capital loss (since the estate's basis is equal to its fair market value at death plus its share of the gain generated by subchapter S corporation sales of the low basis assets), which will be offset by the estate's share of subchapter S gain on the sale of the low basis assets.

If future generations wish to terminate a subchapter S corporation, there may be immediate capital gains consequences in comparison to the assets being held in a partnership or FLLC. If the assets owned by the subchapter S corporation are sold immediately after, or before, the termination, that capital gains comparative disadvantage to a partnership organization may be mitigated. That inside basis disadvantage may also be mitigated by the use of drop-down partnerships and leverage strategies.

- b. Any income of the QSST that does not accrue from subchapter S stock earnings will be taxed under normal subchapter J rules.

As noted above, under Treas. Reg. § 1.1361-1(j)(8), if there is a sale by the trustee of the QSST of any subchapter S stock owned by the QSST, the QSST will be taxed on that sale under normal subchapter J principles. The basis of the subchapter S stock that is to be sold could be

low because the only basis adjustment, after the sale of subchapter S stock, will be the income of the corporation accumulated after the sale. It may be very important to eliminate any note outstanding to the Section 678 owner of the QSST, before the QSST sells its subchapter S stock to a third party, in order to circumvent any income tax complications associated with the outstanding debt.

c. State income tax considerations.

Certain states may have different tax rules with respect to subchapter S corporations and the taxation of QSST trusts. Thus, the possibility exists that under many state laws, a sale to a QSST trust may be subject to state capital gains taxes and the beneficiary of the trust will not be taxed on the trust income. For example, a Missouri trust holds S corporation stock that owns Illinois real estate. When the real estate is sold, Illinois would tax the gain on the real estate, but the capital loss on liquidation of the stock would not be Illinois source loss, because the stock is not Illinois property.

D. Using Two Class Partnerships to Shift Income of a Non-Grantor Trust Residing in a High State Income Tax State to a Low State Income Tax State.

1. Scenario A.

Under certain facts, a complex trust may significantly reduce its income taxes and may increase its net worth, if it invests its assets in a partnership for a preferred interest and a grantor trust invests in the partnership for a growth interest. Consider the following example:

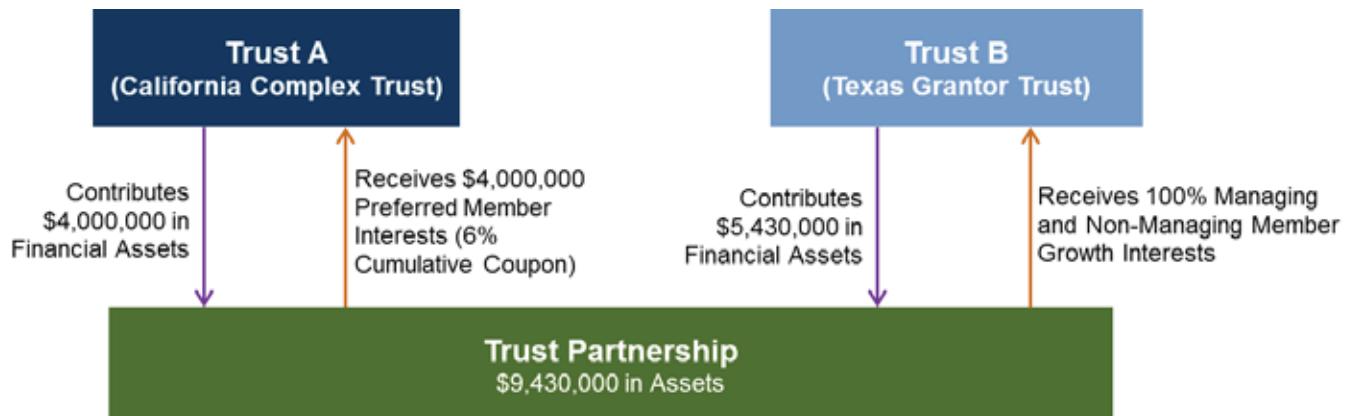
*Example 1: Old Non-Grantor, Complex Trust Enters into a Two-Class Partnership with a New Grantor GST Trust*

*Gomer Gonetotexas is a discretionary beneficiary of a GST Complex trust that was created in California and is subject to California state income tax law (“Trust A”). Gomer now lives in Texas. Gomer has a \$20,000,000 estate and does not need or want any distributions from Trust A. The beneficiaries of Gomer’s estate are the same as the beneficiaries of the California complex trust. Gomer desires to lower the California state income taxes of Trust A and lower his estate taxes. Gomer does not want to pay any gift taxes. Gomer’s living expenses are \$500,000 a year. Gomer develops the following plan:*

*Trust A invests its \$4,000,000 in financial assets for a \$4,000,000 preferred interest in a FLP that pays a 6% cumulative return. Gomer creates Trust B with \$5,430,000 in assets. Trust B is a grantor trust that is also a GST trust with similar beneficial interests to Trust A. (For a discussion of grantor trusts see *infra* Section IV) Trust B contributes its assets for a growth interest in the FLP that is entitled to all of the income and growth of the partnership that is not allocated to the preferred interest. During the term of the partnership there are no distributions to the Trust A beneficiaries. Assume the partnership assets earn 7.4% before taxes a year with 3.4% of the return being taxed at ordinary rates and 4% of the return being taxed at long-term capital gains rates with a 30% turnover.*

The proposed transaction is illustrated below:

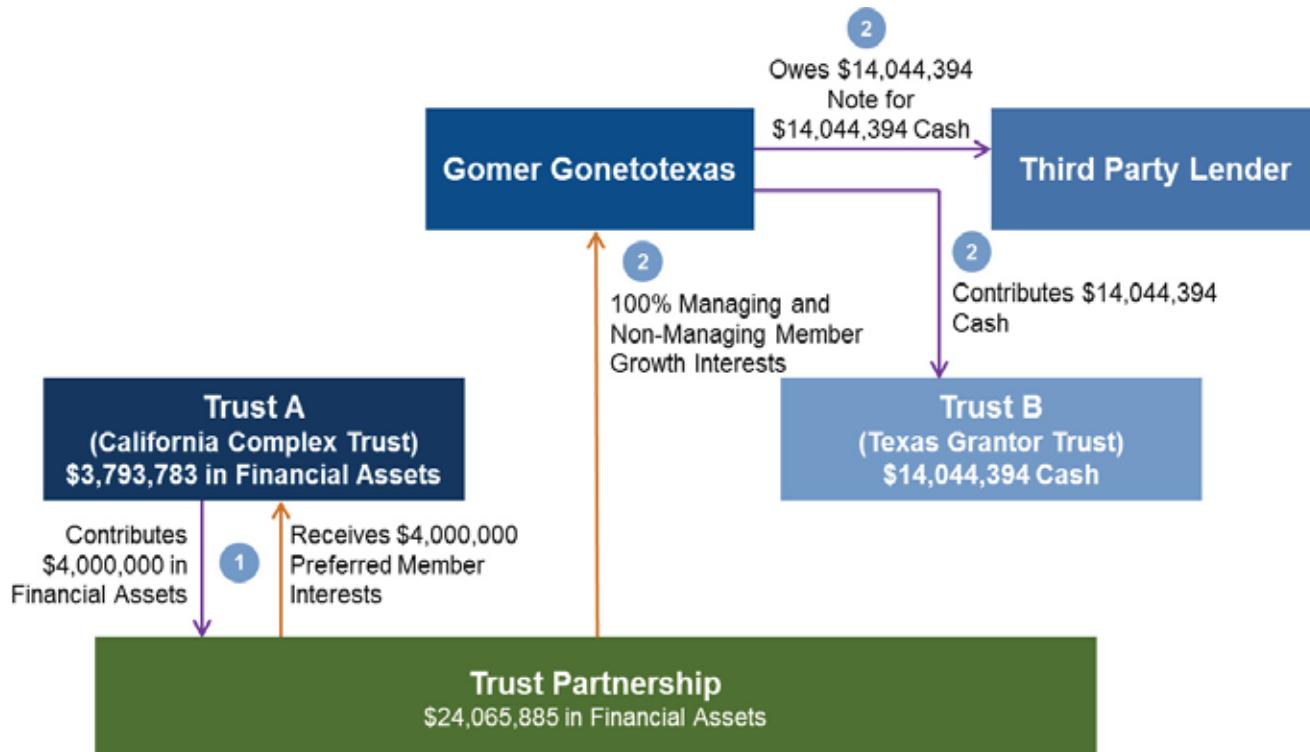
**Transaction 1 (Scenario A):**



**Transaction 2 (Scenario A):**

Assume Gomer, two years before he dies (and eighteen years after the original transaction), manages the contingent income capital gains taxes associated with Trust B's ownership of the growth interest by purchasing the growth interest with cash obtained by borrowing from a third party. *See discussion *infra* Section IV.A.3.a.(13)(d).* That transaction is illustrated below:

Eighteen Years After Scenario A, Gomer Borrows Cash from Third Party Lender and Buys Trust B's Growth Interest in the Trust Partnership for its Fair Market Value



It is assumed that the partnership is terminated shortly before Gomer's death and the third party lender is then paid

2. Income tax advantages of Scenario A.

a. Under this arrangement and the assumed facts, the complex trust's income taxes will be significantly reduced and a significantly greater amount will pass to gomer's descendants.

The technique described is Scenario A in Table 1 below (*also see* attached Schedule 1). Over a 20-year period Trust A will pay 16.2% less in the total of state income taxes and associated investment opportunity costs by using this technique. If the beneficiaries of Trust A, Trust B and Gomer's estate are the same, Gomer's estate will save \$3,380,750 in estate taxes and Gomer's descendants will receive \$38,150,544 in assets in comparison to \$33,727,835 in assets with no further planning.

Table 1

|  | Gonetotexas Beneficiaries |                          | Consumption  |              | IRS Income Taxes |                             | CA Income Taxes |                             | Opportunity Cost/<br>(Benefit) of<br>3rd Party<br>Note | IRS<br>Estate Tax<br>(at 40.0%) | Total        |
|--|---------------------------|--------------------------|--------------|--------------|------------------|-----------------------------|-----------------|-----------------------------|--|---------------------------------|--------------|
|  | Children                  | Children & Grandchildren |              |              | Direct Cost      | Investment Opportunity Cost | Direct Cost     | Investment Opportunity Cost |  |                                 |              |
| <b>20-Year Future Values</b>               |                           |                          |              |              |                  |                             |                 |                             |  |                                 |              |
| No Further Planning                        | \$15,428,576              | \$9,609,259              | \$8,690,000  | \$12,772,329 | \$13,053,175     | \$14,277,270                | \$13,716,783    | \$1,257,693                 | \$977,577  | \$0                             | \$10,285,717 |
| Hypothetical Technique Scenario A          | \$10,357,451              | \$12,333,221             | \$15,459,872 | \$12,772,329 | \$13,053,175     | \$14,389,073                | \$13,719,802    | \$986,747                   | \$887,382  | (\$795,639)                     | \$6,904,967  |
| Hypothetical Technique Scenario B          | \$10,165,130              | \$10,164,400             | \$18,639,941 | \$12,772,329 | \$13,053,175     | \$14,588,078                | \$13,924,521    | \$493,205                   | \$443,626  | (\$951,776)                     | \$6,776,753  |
| <b>Present Values (discounted at 2.5%)</b> |                           |                          |              |              |                  |                             |                 |                             |  |                                 |              |
| No Further Planning                        | \$9,415,611               | \$5,864,252              | \$5,303,254  | \$7,794,581  | \$7,965,974      | \$8,713,003                 | \$8,370,954     | \$767,534                   | \$596,507  | \$0                             | \$6,277,074  |
| Hypothetical Technique Scenario A          | \$6,320,851               | \$7,526,606              | \$9,434,710  | \$7,794,581  | \$7,965,974      | \$8,781,233                 | \$8,372,797     | \$602,183                   | \$541,543  | (\$485,555)                     | \$4,213,901  |
| Hypothetical Technique Scenario B          | \$6,203,483               | \$6,203,038              | \$11,374,804 | \$7,794,581  | \$7,965,974      | \$8,902,680                 | \$8,497,730     | \$300,988                   | \$270,732  | (\$580,841)                     | \$4,135,655  |

b. This technique may be easier to manage than some of the other trust income tax savings techniques.

3. Transfer tax advantages of Scenario A.

- a. The trustee of the complex trust does not have to distribute assets or cash to a beneficiary, or give a withdrawal right to a beneficiary, in order to save income taxes or health care taxes.

As noted above, there may be fiduciary concerns if distributions are made to a beneficiary solely to save income taxes. This technique eliminates that risk.

- b. If the two trusts have identical provisions the valuation rules under IRC Section 2701 may not apply.

IRC Section 2701 valuation rules do not apply for generation skipping purposes. If the two trusts have identical provisions it is difficult to see a gift tax issue or fiduciary issues, if the creator of Trust B is not entitled to any distributions from Trust A because his standard of living is met by other sources.<sup>9</sup> If there is no gift tax or GST tax issue, the trustee of Trust A, because Trust B has the same identical beneficiaries may believe it is in the Trust A beneficiaries' best interest to receive a 3% cumulative preferred interest instead of a 6% cumulative preferred interest in order to save state income taxes.

The technique described above is Scenario A in Table 1 above (*also see* attached Schedule 1). Over a 20-year period Trust A will pay 58.1% less in the total of state income taxes and associated investment opportunity costs by using this technique. If the beneficiaries of Trust A, Trust B and Gomer's estate are the same, Gomer's estate will save \$3,508,964 in estate taxes and Gomer's descendants will receive \$39,968,471 in assets in comparison to \$33,727,835 in assets with no further planning.

4. Considerations of Scenario A.

- a. A party may not exist that could create a grantor trust that could invest and receive a preferred partnership interest.
- b. The technique is complex.
- c. In certain circumstances it may be better for the new grantor trust to own the preferred interest if a high coupon is warranted (e.g. 11% – 12%), because the new grantor trust is contributing 80% – 90% of the assets of the partnership. Under these circumstances, if the leveraged reverse freeze is used, the 80% – 90% preferred interest capitalization could be obtained with minimal gift tax consequences by using a contribution from the new grantor trust. Under those facts, consider scenario B described *infra* Section IV.D.5.

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<sup>9</sup> See Treas. Reg. §25.2511-1(g)(1) and *Saltzman v. Comm.*, 131 F.3d 87 (2nd Cir., 1997).

- d. In certain circumstances it may be more profitable for the old trust to sell the high basis assets to the new trust for a low interest (AFR Rate) note to the new trust.
- e. The IRS may argue that the valuation rules of IRC Section 2701 apply despite the identical provisions and beneficial interests of the two trusts.
- f. If there is not a buy-back of the growth interest by the grantor of the new grantor trust before the death of the grantor much of the income tax benefit will be lost because of the lack of step-up that accrues for the assets held in the new grantor trust.

5. Scenario B.

Under certain assumptions, it may make sense to employ Scenario B: the preferred partnership interest is owned by a grantor trust in a low state income tax state and the growth interest is owned by a complex trust located in a high state income tax state.

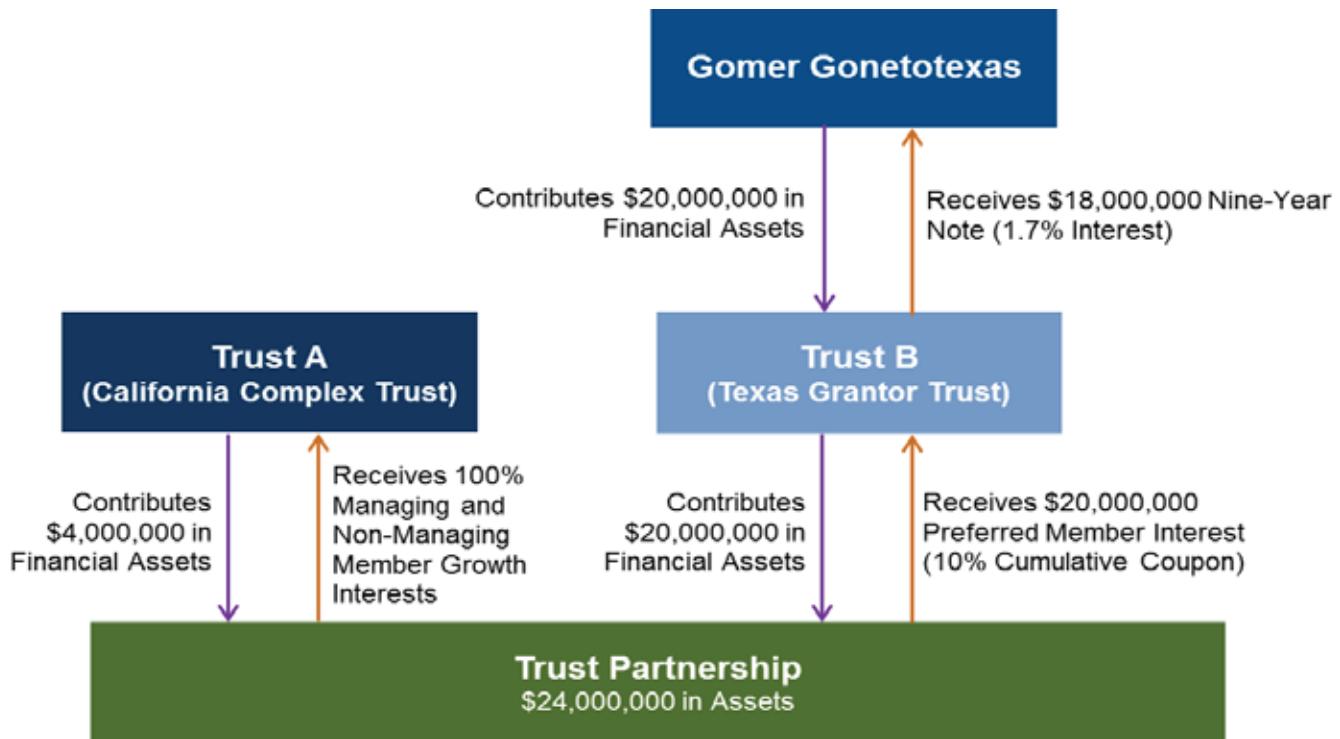
Consider the following example:

*Example 2: A Leveraged Reverse Freeze is Used to Shift Trust Taxable Income from a High Income Tax State to a Low Income Tax State*

*The facts are similar to Example 1, except Gomer Gonetotexas contributes all of his net worth (\$20,000,000) to a partnership with Trust A and receives a mezzanine preferred partnership interest that pays a cumulative coupon with a coupon rate that is consistent with Revenue Ruling 83-120 (that rate for purposes of this example is assumed to be 10%). Trust A will receive the growth interest. Gomer then contributes \$2,000,000 of the preferred interest and sells \$18,000,000 of his preferred interest to Trust B, which has the same provisions as Example 1, in exchange for a nine-year note that pays an AFR interest rate.*

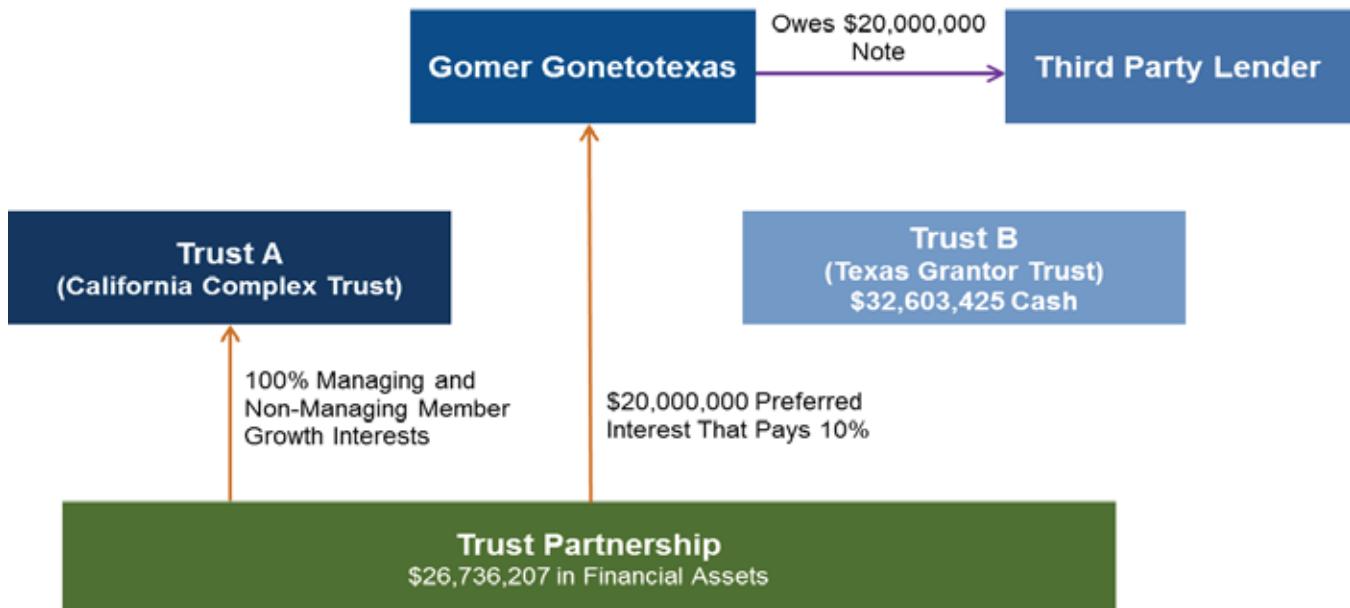
This example is illustrated below:

**Transaction 1 (Scenario B):**



### Transaction 2 (Scenario B):

Seventeen Years After Scenario A, Gomer Borrows Cash from Third Party Lender and Buys Trust B's Preferred Interest in the Trust Partnership for its Fair Market Value



## 6. Income tax advantages of Scenario B.

a. Significant state income taxes and the investment opportunity costs associated with those state income taxes can be saved with this technique.

See Table 2 below and attached Schedule 2. In this technique all of the potential state income taxes and the opportunity costs associated with those state income taxes are eliminated. Under the assumptions of this Example 2, \$1,264,013 in state income taxes will be saved and \$995,794 in investment opportunity costs on those state income taxes will be saved for a total savings of \$2,259,807.

b. Under the right facts, many of the state income tax advantages of this Scenario B will exist as they do for scenario A discussed *supra* Section III.D.2. and 3.

## 7. Transfer tax advantages of Scenario B.

a. Significant transfer taxes will be saved under this scenario.

See Table 2 below and attached Schedule 2. Under the assumed facts of this Example 2, all of the estate taxes are eliminated.

Table 2

| Gonetotexas Beneficiaries                  |              | Children & Grandchildren |              | Consumption  |              | IRS Income Taxes |              | CA Income Taxes |           | Opportunity Cost/ (Benefit) of 3rd Party Note |              | IRS Estate Tax (at 40.0%) |  | Total |  |
|--|--------------|--------------------------|--------------|--------------|--------------|------------------|--------------|-----------------|-----------|---|--------------|---------------------------|--|-------|--|
|  |              |                          |              |              |              |                  |              |                 |           |   |              |                           |  |       |  |
| <b>20-Year Future Values</b>               |              |                          |              |              |              |                  |              |                 |           |   |              |                           |  |       |  |
| No Further Planning                        | \$15,428,576 | \$9,609,259              | \$8,690,000  | \$12,772,329 | \$13,053,175 | \$14,270,950     | \$13,698,567 | \$1,264,013     | \$995,794 | \$0   | \$10,285,717 | \$100,068,380             |  |       |  |
| Hypothetical Technique                     | \$0          | \$4,000,000              | \$43,359,947 | \$12,772,329 | \$13,053,175 | \$15,967,067     | \$14,173,982 | \$0             | \$0       | (\$3,258,119)                                 | \$0          | \$100,068,380             |  |       |  |
| <b>Present Values (discounted at 2.5%)</b> |              |                          |              |              |              |                  |              |                 |           |   |              |                           |  |       |  |
| No Further Planning                        | \$9,415,611  | \$5,864,252              | \$5,303,254  | \$7,794,581  | \$7,965,974  | \$8,709,146      | \$8,359,837  | \$771,391       | \$607,704 | \$0   | \$6,277,074  | \$61,068,825              |  |       |  |
| Hypothetical Technique                     | \$0          | \$2,441,084              | \$26,461,316 | \$7,794,581  | \$7,965,974  | \$9,744,237      | \$8,649,969  | \$0             | \$0       | (\$1,988,336)                                 | \$0          | \$61,068,825              |  |       |  |

- b. The trustee of Trust B may wish to use some of its positive cash flow from the transaction to purchase life insurance on the life of Gomer Gonetotexas, at least to the extent there may be estate taxes associated with Gomer's note.

The insurance could serve as a hedge to Gomer's early death. *See* discussion *infra* Section IV.C.4.d.(5)(c)(i).

- c. In general, this Scenario B has the same transfer tax advantages discussed in Scenario A, *see supra* Section III.D.2. and 3.

#### 8. Considerations of Scenario B.

Scenario B has many of the same considerations that are discussed *supra* Section III.D.4.

#### E. The Use of a High-Yield Preferred Partnership or Membership Interest with a Charitable Lead Annuity Trust ("CLAT") to Make Distributions to a Contributor's Favorite Charities.

##### 1. What is a CLAT?

- a. A CLAT is a trust in which the lead interest is payable to a charity and is in the form of an annuity amount for the term of the lead interest.
- b. In the CLAT, the annual payment is not based on the income of the trust. Since the annuity amount is not based on the income of the trust, that amount must be paid to the charity even if the trust has no income. If the trust's current income is insufficient to make the required annual payment, the short fall must be made up out of the invasion of the trust principal. If the current income exceeds the required annual payment, it does not have to be paid over to the charity; however, the excess income would then be accumulated and added to the trust corpus.
- c. The lead interest in a CLAT can be for a fixed term of years. Unlike a charitable remainder trust, the fixed term can be indefinite.<sup>10</sup> The lead interest can also be measured by the life of an existing individual or the joint lives of existing individuals.
- d. CLATs are not subject to the minimum payout requirements associated with charitable remainder trusts. Thus, there is no 5% minimum pay out for CLATs.

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<sup>10</sup> IRC Section 170(f)(2)(B).

- e. The CLAT is not a tax-exempt entity, unless the CLAT is a grantor trust. If the CLAT is a non-grantor trust and if taxable income is accumulated in the trust it will be subject to income taxes. The CLAT will receive a charitable income tax deduction when it makes the distribution to the charity. If the CLAT is a grantor trust, the grantor will receive an income tax deduction for the actuarial value of the charitable gift of the annuity amounts upon creation of the CLAT. If the CLAT is a grantor trust, there will not be any future income tax deductions for distributions to charities.
- f. CLATs are characterized as private foundations for purposes of certain restrictions placed on such organizations. Accordingly, CLATs are subject to private foundation excise tax provisions.<sup>11</sup> The governing trust instrument must contain specific prohibitions against (i) self-dealing; (ii) excess business holdings; (iii) jeopardy investments; and (iv) taxable expenditures.<sup>12</sup> If the specified prohibited transactions occur onerous significant excess taxes could accrue.

2. The technique.

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

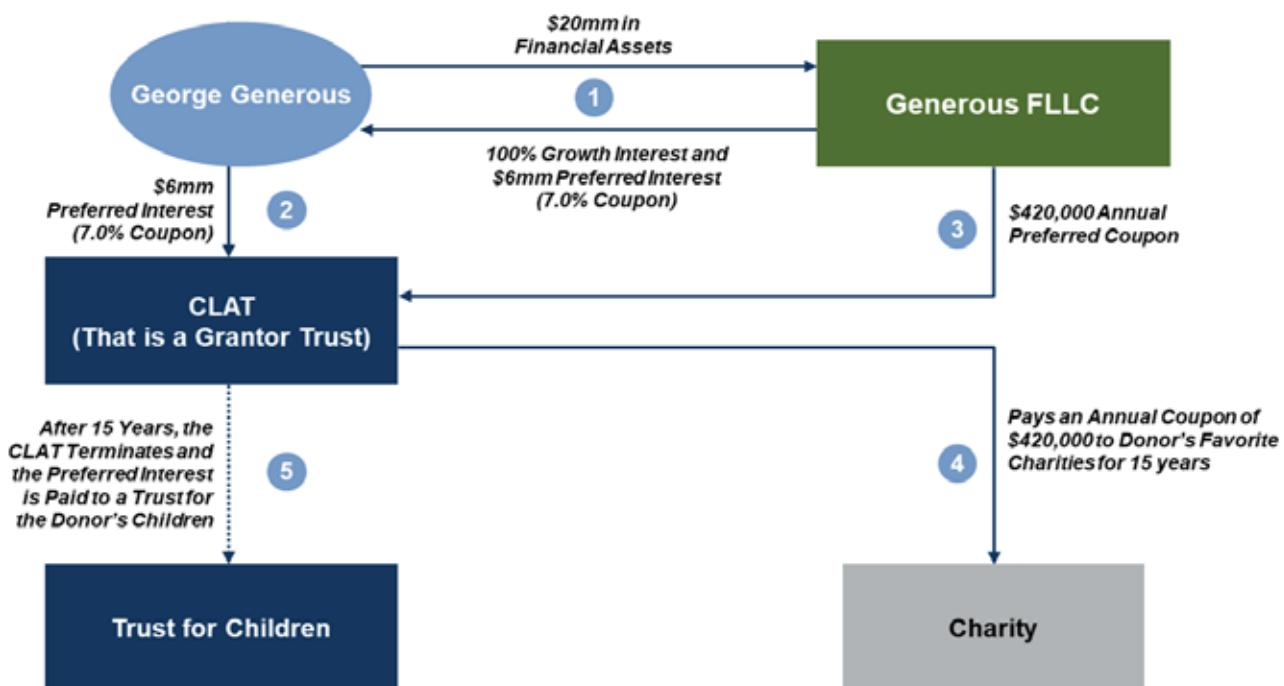
If a taxpayer creates a preferred interest in a FLP or a FLLC and contributes that preferred interest to a CLAT, the success of the CLAT is virtually assured. This is because all of the assets and the income of all of the assets of the FLP or FLLC are available to ensure the success of the coupon payments that are made on the preferred interest that is contributed to the CLAT. Assuming the preferred coupon rate is substantially in excess of the IRC Section 7520 rate, substantial assets will be available to the remainder beneficiaries of the CLAT on its termination.

Consider the following Example 3, where the gift of the preferred interest is a 15-year CLAT (when the IRC Section 7520 rate is 3.4%) is treated as a grantor trust:

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<sup>11</sup> IRC Section 4947(a)(2).

<sup>12</sup> See IRC Sections 4941(a)-(b), 4943(a)-(b).



3. Income tax advantages of the technique.

- The donor will not pay income taxes or healthcare taxes on income that is allocated to the CLAT, if the CLAT is a conventional CLAT and is not a grantor trust.
- The donor will receive an upfront deduction against income taxes for the actuarial value of the annuity interest paid to charity if the CLAT is a grantor trust.
- Income tax valuation advantage: IRS concedes preferred partnership interests should have a high coupon.

Prior to passage of IRC Section 2036(c) in 1987 (which was repealed in 1990) and prior to the passage of IRC Section 2701 as part of Chapter 14 in 1990, the IRS did not have many tools with which to fight, from their perspective, abusive estate freezes, except valuation principles. In 1983, the IRS issued a Revenue Ruling,<sup>13</sup> which promulgated the factors for determining what an appropriate coupon should be on preferred stock of a closely held corporation or what an appropriate coupon should be on a preferred partnership interest in a closely held FLP. Generally, the IRS took the view that a secondary market does not exist for interests in FLPs. Accordingly, with respect to a preferred partnership interest in a FLP, the coupon should be very high in order to reflect the embedded marketability discount of the preferred partnership interest. In other words, according to the IRS, to have a preferred partnership interest valued at “par”, a hypothetical willing buyer would demand a significant

<sup>13</sup> Rev. Rul. 83-120, 1983-2 C.B. 170.

return on that preferred partnership interest, in comparison to other comparable fixed income instruments, in order to compensate that hypothetical willing buyer for the lack of marketability that would be inherent in that family limited preferred partnership interest.

- d.     IRC Section 2036 avoidance advantage, if George gives or sells the growth interests to his family.

If the growth member interest is transferred to the donor's family after the preferred member interest is transferred to a public charity IRC Section 2036 should not operate to include the transferred common interest (or the underlying partnership assets) in the transferor's gross estate, for two reasons.

First, there is a substantial investment purpose (i.e., non-tax purpose) with having preferred and common interests that divide the economic return of the FLP or FLLC between the owners of the interests in a different way than would result without the two interests. This creates is a substantive investment reason for the creation of the FLP or FLLC. As such, it should constitute a significant non-tax purpose, one that is inherent in the preferred/common structure. This in turn should minimize the danger of IRC Section 2036 being applied to any transfers of interests in the FLP or FLLC, because the Tax Court and the Courts of Appeal are much less likely to apply IRC Section 2036 to transferred FLP or FLLC interests if a non-tax reason, preferably an investment non-tax reason, exists for the creation of the FLP or FLLC.<sup>14</sup>

Second, the enactment of IRC Section 2036(c) (in 1988) and its subsequent repeal (in 1990) demonstrates that going forward Congress intended to address the preferred/common structure solely by means of the gift tax rules of Chapter 14 (IRC Section 2701) and *not* by including the transferred common interest in the transferor's gross estate under IRC Section 2036. The legislative history of the repeal of IRC Section 2036(c) unmistakably manifests this Congressional intent. Thus, even if the transfer of the growth interests occurs at the taxpayer's death, because of that strong legislative intent, IRC Section 2036 should not apply.

In 1988, the Tax Court in the *Boykin*<sup>15</sup> case ruled that because of state property law,<sup>16</sup> the receipt of income from retained preferred stock is only a retention of income from the preferred

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<sup>14</sup> *Estate of Kimbell v. United States*, 371 F.3d 257 (5th Cir. 2004); *Church v. United States*, 85 A.F.T.R. 2d (RIA) 804 (W.D. Tex. 2000), *aff'd without published opinion*, 268 F.3d 1063 (5th Cir. 2001) (per curiam), unpublished opinion available at 88 A.F.T.R. 2d 2001-5352 (5th Cir. 2001); *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005); *Estate of Stone v. Commissioner*, 86 T.C.M. (CCH) 551 (2003); *Estate of Schutt v. Commissioner*, T.C. Memo 2005-126 (May 26, 2005); *Estate of Mirowski v. Commissioner*, T.C. Memo 2008-74; *Estate of Miller v. Commissioner*, T.C. Memo 2009-119; *Rayford L. Keller, et al. v. United States of America*, Civil Action No. V-02-62 (S.D. Tex. August 20, 2009); *Estate of Murphy v. United States*, No. 07-CV-1013, 2009 WL 3366099 (W.D. Ark. Oct. 2, 2009); and *Estate of Black v. Commissioner*, 133 T.C. 340 (2009) and *Shurtz v. Commissioner*, T.C. Memo 2010-21.

<sup>15</sup> See *Estate of Boykin v. Commissioner*, T.C. Memo 1987-134, 53 T.C.M. (CCH) 345.

<sup>16</sup> Under certain Supreme Court holdings, in determining the value for gift and estate tax purposes of any asset is transferred, the legal rights and interests inherent in that transferred property must first be determined under

stock, not from the assets of the entire enterprise and accordingly should be included in a decedent's estate under IRC Section 2033, and not under IRC Section 2036. The court concluded that Mr. Boykin did not have a legal retained property right to the income of the assets of the corporation, he only retained a legal right to the income of the retained preferred stock.

In 1988 Congress passed legislation to overturn the result of *Boykin*, IRC Section 2036(c). For a very brief period, 1988 to 1990, IRC Section 2036(a), when it applied, did operate to include the partnership assets of a partnership in which a preferred partnership interest was created to the exclusion of IRC Section 2033. (While IRC Section 2033 also could have applied in 1987 to include the same partnership interests, Congress was very careful to reverse the traditional priority of IRC Section 2033 inclusion over IRC Section 2036 inclusion with the passage of IRC Section 2036(c)(5)). In 1988, Congress explored whether or not to do away with minority and marketability discounts with respect to family partnership and family corporations and whether to attack so-called estate freezes. At that time, Congress decided not to attack FLP discounts or discounts associated with family corporations. However, Congress decided to attack so-called estate freezes by making estate freezes that met six defined tests (described in IRC Section 2036(c)) subject to the IRC Section 2036(a) inclusion.

#### 4. Considerations of the technique.

- a. The partial interest rule should not apply for gift tax purposes or income tax purposes (if a grantor CLAT is used), but the IRS may make the argument.

The income tax deduction is obviously unimportant if a non-grantor CLAT is used, because the gift on the annuity in a non-grantor CLAT is not eligible for an income tax deduction. What if the CLAT is a grantor trust? It is then important to receive an upfront income tax deduction. The question then becomes whether IRC Section 170(f)(3), which denies a charitable deduction for a contribution to charity (not made by a transfer in trust) of certain partial interests in properly, trumps the deduction allowed under IRC Section 170(f)(2) for gifts to grantor CLATs. The answer should be no.

IRC Section 170(f)(3) denies an income tax charitable deduction, and IRC Section 2522(a)(2) denies a gift tax charitable deduction, for a contribution of an interest in property that consists of less than the taxpayer's entire interest in such property. A gift of the entirety of an asset or an undivided portion of the taxpayer's entire interest in property to a charity does qualify for the income tax and gift tax charitable deduction. The undivided portion of the taxpayer's

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state law. *See United States v. Bess*, 357 U.S. 51 (1958); *Morgan v. Commissioner*, 309 U.S. 78 (1940); *see also* H. REP. NO. 2543, 83rd Cong. 2nd Sess., 58-67 (1954); H.R. REP. NO. 1274, 80th Cong. 2nd Sess., 4 (1948-1 C.B. 241, 243); S. REP. NO. 1013, 80th Cong., 2nd Sess., 5 (1948-1 C.B. 285, 288) where the Committee Reports on the 1948 changes in the estate taxation of community property states: "Generally, this restores the rule by which estate and gift tax liabilities are dependent upon the ownership of property under state law." *See also* the reports of the Revenue Act of 1932 that define "property" to include "every species of right or interest protected by law and having an exchangeable value." H.R. REP. NO. 708, 72nd Cong., 1st Sess., 27-28 (1932); S. REP. NO. 665, 72nd Cong., 1st Sess., 39 (1932).

entire interest in property must consist of a fraction or percentage of each and every substantial interest or right the decedent owned in the property. IRC Section 170(f)(3)(B)(ii) and Treas. Reg. § 1.170A-7(b) provide that a deduction is allowed for a contribution, that is not in trust, of a partial interest that is less than the donor's entire interest in property if the partial interest is an undivided portion of the donor's entire interest. An undivided portion of a donor's entire interest in property must, however, consist of a fraction or percentage of *each and every substantial interest or right* owned by the donor in such property. *See* Rev. Rul. 88-37, 1988-1 C.B. 97 (1988).

The Tax Court in the *Estate of John Boykin*<sup>17</sup> held that an ownership of a preferred equity interest does not entitle the owner to any rights to the assets of the entity – it only entitles the owner to rights in the preferred interest. Any gift of the preferred interest should be analyzed as a gift of the preferred interest not a gift of certain rights over the entity's assets. Consistent with the *Boykin* case cited above, the preferred interest should be considered to be a separate interest both from the FLLC's assets and from George's other interests in the FLLC. The separate preferred interest is transferred in its entirety. In this example, all of George's preferred interest passes to charity – he does not retain any interest in the preferred interest or make a gift of part of the preferred interest, so the transfer is not “a contribution (not made by a transfer in trust) of an interest in property which consists of less than the taxpayer's entire interest in such property.” IRC Section 170(f)(3).

On the gift tax side (*see* IRC Section 2522(c)(2)) there are two Supreme Court cases stating that the gift tax consequences should be applied in a manner that follows a state property law analysis.<sup>18</sup>

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<sup>17</sup> *Estate of Boykin v. Commissioner*, T.C. Memo. 1987-134, 53 T.C.M. 345. *See also Hutchens Non-Marital Trust v. Commissioner*, 66 T.C.M. (CCH) 1599 (1993) (The Tax Court held that the interest that the decedent held in his family-owned corporation prior to recapitalization was not includible in his gross estate under IRC Section 2036 because the decedent received adequate consideration for the pre-recapitalization stock, the decedent retained no interest in stock surrendered in the recapitalization, and the decedent's post-recapitalization control and dividend rights came from new and different forms of preferred stock that he received in the recapitalization.) *See also* private letter rulings 8950071 (issued on September 21, 1989), 9022010 (issued on February 27, 1990) and 201129033 (issued on July 22, 2011). In each of these private letter rulings the IRS ruled that in the case where a donor owned different classes of corporate stock with different rights, the “partial interest” rule was not violated when only one class of stock was donated to charity. *See also* Todd Angkatavanich, Jonathan G. Blattmachr and James R. Brockway, “Coming Ashore – Planning for Year 2017 Offshore Deferred Compensation Arrangements: Using CLAT’s, PPLI and Preferred Partnerships and Consideration of the charitable Partial Interest Rules,” 39 ACTEC Law Journal 103, 130-145, 152-153. The authors discuss *McCord v. Commissioner*, 120 T.C. 358 (2003), rev'd and remanded, 461 F.3d 614 (5th Cir. 2006), *Church v. United States*, 85 A.F.T.R. 2d 2000-804 (W.D. Tex. 2000), aff'd 268 F.3d 1063 (5th Cir. 2001), and *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), aff'd in part and remanded in part, 293 F.3d 279 (5th Cir. 2002), on remand 85 T.C.M. (CCH) 1331 (2003), aff'd 417 F.3d 468 (5th Cir. 2005) and conclude that a gift of a preferred interest to a charity should not be considered a gift of a partial interest because the courts follow the entity rule in determining the property rights associated with a partnership interest. The authors also conclude the argument is strengthened if the gift of a preferred interest is made to a qualifying trust (e.g., a charitable lead trust) and/or the donor only owns the donated preferred interest and does not own any other interest in the partnership.

<sup>18</sup> *See United States v. Bess*, 357 U.S. 51 (1958); *Morgan v. Commissioner*, 309 U.S. 78 (1940).

State law does not treat a partnership interest as a partial interest in the underlying assets of the partnership. A partner is not a co-owner of partnership property and has no interest in partnership property that can be transferred, either voluntarily or involuntarily. *See* Revised Uniform Partnership Act, § 501. The only transferable interest of a partner in the partnership is the partner's share of the profits and losses of the partnership and the partner's right to receive distributions. Ownership of a partnership interest does not entitle the owner to any rights over property owned by the partnership. Revised Uniform Partnership Act, § 502; *Michtom v. United States*, 573 F.2d 58, 63 (Ct. Cl. 1978); PLR 9825001. Partnerships are distinct entities. Revised Uniform Partnership Act, § 201.

Despite state property law, there is a possibility that the IRS could attempt to deny a charitable deduction for a contribution of preferred units. Treas. Reg. § 1.170A-6(2) allows a deduction for a contribution of a partial interest in property only “if such interest is the taxpayer’s entire interest in the property, such as an income interest or a remainder interest.” “If, however, the property in which such partial interest exists was divided in order to create such interest and thus avoid IRC Section 170(f)(2), the deduction will not be allowed.” *Id.* The IRS may take the position that IRC Section 170(f)(3) can apply despite the fact that a contributed interest becomes a separate property interest for federal tax purposes as a result of the transfer. For instance, the IRS has denied charitable deductions in situations where the donor had donated common stock but retained the right to vote that stock (*see* Rev. Rul. 81-281, 1981-2 C.B. 78; PLR 8136025) because the right constitutes a substantial interest. Carving the right to vote away from the economic interest in the common stock created a non-deductible partial interest.

Similarly, in Rev. Rul. 88-37, the IRS denied a deduction because the donor did not contribute the donor’s entire interest in his property but carved out and contributed only a portion of that interest. Further, the portion contributed was not an undivided portion of the donor’s entire interest—it did not convey a fraction of each and every substantial right owned by the donor in the property. By transferring an overriding royalty interest or a net profits interest, the donor retained the right inherent in the “working interest” (the ownership of an operating interest under an oil and gas lease) to participate in the control of, the development and operation of the lease. This right to control or to participate in the control, similar to the retained voting rights in Rev. Rul. 81-282, is a substantial right, the retention of which prevented the donated interest from being considered an undivided portion.

There are numerous business and financial reasons to form a partnership or FLLC as an advantageous vehicle for, and being in the best interests of, the members of a family, including consolidation of the management and control of family assets within a partnership owned by the eventual owners of all of the assets; avoidance of fractional asset ownership over time; greater creditor protection; greater ability to keep assets in the family, etc. The more of these factors that are applicable to any proposed FLLC the less likely the contribution of preferred units will be attacked as a prohibited gift of partial interests.

The proposed FLLC should be created for reasons independent of obtaining a charitable deduction and independent of avoiding section 170(f)(3). The fact that the charitable deduction is likely to be only 30% of the value of the preferred units given away may demonstrate that other reasons are more important than the charitable deduction. The more participants in the

FLLC the more likely it was created for purposes independent of obtaining a charitable deduction and the less likely the IRS will deny the charitable contribution as a gift of a partial interest.

Consequently, it is important to establish that the purpose of the FLLC is not to slice the voting rights from the FLLC's underlying securities by retaining the managing units (which control the FLLC and thereby control the vote of the underlying securities) and donating only the preferred units (which carry no control over the FLLC). Having an independent entity from the donor as a manager will strengthen the donor's position.

Another factor that could bolster the argument that the FLLC was not created for purposes only related to dividing the economic interests of the contributed property to the FLLC in order to circumvent the partial interest rule is the longevity of the FLLC before gifts are made to charity. The longer the FLLC exists prior to the contribution, the more a separate purpose would be indicated. *See Rev. Rul. 86-60, 1986-1 C.B. 302* (four-year delay between creation of partial interest and proposed contribution); *Rev. Rul. 76-523, 1976-2 C.B. 54* (1976) (split of interests in stock was for business purpose and done years before the transfer to charity); *PLR 20010812* (eight-year delay between the donor's transfer of voting rights in common stock to a voting trust and her charitable donation of that stock); *PLR 9721014* (ten-year delay between creation of partial interest and the proposed contribution).

In addition to the above arguments and analysis, there is the additional benefit of having the gift structured as a gift of an annuity interest in a charitable lead annuity trust. The sought-after deduction is not for the contribution of the partial interest to the trust, but rather for the contribution of the term interest in the trust to charity. The deduction must be allowable "*with respect to the trust*," not with respect to the assets contributed to the trust. The charitable deduction is specifically allowed by IRC Section 170(f)(2) for the contribution of the term interest in the grantor lead trust. Here, the deduction is allowable with respect to the grantor lead trust as long as the grantor lead trust otherwise meets the description of IRC Section 664. Second, IRC Section 170 (f)(3) specifically refers to contributions "not made by a transfer in trust", whereas IRC Section 170(f)(2) refers to contributions "in trust." IRC subsections 170(f)(2) and 170(f)(3) are mutually exclusive: the first applies to contributions in trust and the second applies to contributions outside of trust.

Concerns about the partial interest issue arise from Private Letter Ruling 9501004. This ruling involved a charitable trust funded with an option to purchase real estate. The donor contributed an option to purchase real estate instead of contributing real estate itself because the real estate was encumbered by debt. According to the ruling, an option does not, before exercise, vest in the optionee any interest, estate or title in the land. Accordingly, the taxpayer would not be allowed a charitable deduction in the year in which the option was granted but would be allowed a deduction in the year in charitable organization exercised the option. *See Rev. Rul. 82-197, 1982-2 CB 1982*.

In that ruling, the IRS disregarded the specific language of Treas. Reg. § 1.664-1(a)(1)(iii). That section defines qualified charitable remainder trusts as *trusts* for which an income or transfer tax deduction is *allowable*. It does not require that each contribution to a trust must be independently deductible in order for the trust to qualify. As justification for ignoring this

distinction, the IRS relies upon its “function exclusively” weapon of Treas. Reg. § 1.664-1(a)(4), which requires that the charitable remainder trust at all times throughout its existence must “meet the definition of and function exclusively as a charitable remainder trust.” Using this weapon, the IRS read into IRC Section 1.664-1(a)(1)(iii) a requirement that each asset contributed to the trust must independently qualify for a charitable deduction under IRC Sections 170, 2055, 2106 or 2522 in order for the trust to be, and to function exclusively as, a charitable remainder trust “in every respect.” There is no direct authority to support this argument as there is no direct authority regarding what constitutes meeting the definition of and functioning exclusively as a charitable remainder trust.

Based on this questionable interpretation of the statute and the regulation’s language, the IRS proceeded to discuss the denial of the income tax deduction based on the partial interest rule of IRC Section 170(f)(3). The IRS posited an example where the property contributed to the trust ultimately passed outside the trust: the facts in the ruling indicated that the option would never be exercised by a charitable organization or trust, but rather would be assigned to a third party. Then, relying on the partial interest rule of IRC Section 170(f)(3) (not 170(f)(2)), the IRS denied the income tax deduction because the contribution was of a partial interest which passed *outside* of the trust. The ruling goes out of its way to say: “However, no deduction would be allowable under [the partial interest rule] for any payment made to such a third party purchaser that purchases and exercises the purported option. In such a situation, the payment by Taxpayer would be made to the third party charitable organization *outside the trust* [emphasis added].”

That statement would not be necessary if the option itself, as a partial interest, disqualified the trust.

It is also important for purposes of the gift tax charitable deduction whether the partial interest rule applies. As discussed below, the partial interest rule should also not apply for gift tax purposes. Even if the income tax deduction is denied under IRC Section 170, the CLAT still qualifies for a gift tax deduction because a gift tax deduction remains allowable under IRC Section 2522. IRC Section 2522 does not appear to incorporate a 170(f)(3)-type partial interest rule. PLR 9501004 did not address whether IRC Section 2522 indirectly incorporates a partial interest rule because the gift was found to be incomplete. “Such [an incomplete] transfer would not constitute a transfer to the Trust for which a gift tax charitable deduction is allowable with respect to the Trust.” The converse is implied to be true - if the payment by Taxpayer would be made to a charitable organization inside a trust, such a transfer would constitute a transfer for which a gift tax charitable deduction is allowable with respect to the trust.

The IRS did not import a 170(f)(3)-type partial interest rule into IRC Section 2055 in its private letter ruling 200202032. In that ruling, the taxpayer had previously contributed to the museum all of his right, title and interest in and to a 50% undivided interest in 32 paintings. At his death, the taxpayer bequeathed his remaining 50% undivided interest in the 32 paintings to the museum. The ruling held that the taxpayer’s 50% undivided interest qualified for the estate tax charitable deduction under IRC Section 2055, despite being partial interests.

IRC Sections 170(f)(2), 170(f)(3), 2055(e)(2) and 2522(c)(2) were enacted as part of a comprehensive revision of the tax treatment of charitable contributions in the Tax Reform Act

of 1969, Pub. L. No. 91-172, 83 Stat. 487. In that legislation, Congress provided rules governing charitable gifts of partial interests outside of trust, *see* IRC 170(f)(3); income tax deductions for gifts in trust, *see* IRC Section 170(f)(2); estate tax deductions, *see* IRC Section 2055(e)(2), and gift tax deductions, *see* IRC Section 2522(c)(2). Notably, Congress did not include a corresponding IRC Section 170(f)(3)-like provision in IRC Sections 2055 or 2522.

The legislative history concerning income tax deductions for gifts of partial interests not in trust weighs against importing the same restrictions into IRC Sections 2055 and 2522. The history focused on the practice of taking a deduction for the donation of the rent-free use of property for a specified time. Congress agreed with the IRS's position that in such a situation a taxpayer obtains a double benefit by being able to claim a deduction for the fair rental value of property and also exclude from income the receipts from the donated interest during the period of the donation. The legislative solution was to permit the exclusion but deny an income tax deduction. *See* H.R. Rep. No. 413, 91<sup>st</sup> Cong., 1<sup>st</sup> Sess. 57-58 (1969), 1969-3 C.B. at 239. This solution is not relevant in the transfer tax context.

- b. Care should be taken to make sure that there is not a tax on excess business holdings under IRC Section 4943.

This example assumes the FLLC owns only financial assets. If the FLLC owns a trust or business, since the CLAT will be considered a private foundation, the excess business holding rules and IRC Section 4943 need to be considered.

- c. If the CLAT is a grantor trust the grantor will pay the income taxes on the earnings of the CLAT.

However, from a transfer tax planning point of view, that is generally advantageous.

F. Creation of a Non-Grantor Trust That is Not a Completed Gift for Gift Tax Purposes (“ING” Trust).

1. As noted *supra* Section III.A. - E., there can be numerous income tax advantages associated with non-grantor trusts.
2. Non-grantor trusts in which there is a completed gift have certain considerations that a non-grantor trust that is not a completed gift for gift tax purposes does not have.
  - a. The creation of the trust will use the grantor's exemption and/or result in gift taxes unless a marital deduction is available.
  - b. In order to be a completed gift the grantor must release dominion and control and generally may not have a beneficial interest.
3. Designing a trust that is an ING trust for gift tax purposes, but is a non-grantor trust for income tax purposes, is difficult.

While the ING trust must be designed carefully to provide that the grantor does not retain powers over the trust for income tax purposes that would make it a grantor trust under IRC Sections 671-677, the ING trust must also be carefully designed to provide that the grantor of that trust has enough retained powers over the ING trust to make the grantor's transfer of assets to the trust incomplete for gift tax purposes.

Currently, a popular design of such a trust provides that the trust will be irrevocable; during the existence of the trust all distributions of income and principal may be made by the trustee to the grantor and/or the grantor's issue, but solely at the direction of a distribution committee; the distribution committee consists of the grantor and several of his issue and functions in a non-fiduciary capacity; decisions of the distribution committee may be executed either by the grantor and a majority of the other members of the distribution committee, or unanimously by all members other than the grantor; the grantor retains a power of appointment over the remainder of the trust; and the grantor retains the sole power to make trust distributions from trust principal under a reasonably definite standard for the health, education and support of his issue.<sup>19</sup>

- a. The grantor of the ING trust must not retain controls that trigger grantor trust status.
  - (1) The power to control beneficial enjoyment under IRC Section 674, the power to revoke the trust and reinvest trust property under IRC Section 676, and the power to distribute income for the benefit of the grantor or the grantor's spouse under IRC Section 677, even if held by the grantor, will not trigger grantor trust status if the grantor's power is only exercisable with an adverse party's approval.

An adverse party is defined under IRC Section 672(a) as “any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power.” Thus, if potential beneficiaries are members of a distribution committee, that is designed as noted above, IRC Sections 674, 676 and 677 should not be available to make the trust a grantor trust, unless Treas. Reg. §1.677(a)-1(d) applies.

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<sup>19</sup> Recent PLRs include: PLRs 201310002 to 201410006, PLRs 201410001 to 201410010, PLRs 201426014 (revoked by PLR 201642019 because of a somewhat hidden reversionary interest which caused grantor trust status), PLR 201427008; PLRs 201427010 to 201427015, PLRs 201430003 to 2014-30007; PLRs 201436008 to 201436012, PLR 201438010 to 201438014 (these were not INGs, but may be of interest because they had a similar distribution committee), PLRs 201440008 to 201440012, PLRs 201510001-201510008 (guardians for minors on the distribution committee), PLR 201550005 (funded with community property), PLR 201613007, PLR 201757001, PLRs 2018-32005 to 2018-32009, PLR 2018-36006 (includes another trust as beneficiary/potential appointee), PLR 201838003, PLRs 201848002 to 201848009, PLRs 201850001 to 201850006, PLRs 201852005 to 2018-52018, PLR 201902027, PLR 201908003 to PLR 201908007.

Under that regulation a trust is a grantor trust under IRC Section 677, even if an adverse party must consent to the exercise of a power, if its income is actually applied, or may be applied at the discretion of the trustee, or must be applied by the trustee to discharge the debts or other legal obligations of the settlor or the settlor's spouse.<sup>20</sup> As a consequence, a self-settled trust that is located in a state where the common law rules apply to allow creditors to reach trust assets created for the grantor's own benefit, despite the presence of a spendthrift clause, will be deemed a grantor trust in those states. However, there exist 19 states where those common law rules do not apply (those states are sometimes referred to as "DAPT states" because they permit Domestic Asset Protection Trusts, or "DAPTs"). Spendthrift provisions of trusts located in DAPT states may prevent grantor trust status from applying under IRC Section 677. It should be noted that, because of developing creditor protection law, creditor protection may be in some doubt for residents of common law states creating trusts subject to the laws of DAPT states. It should also be noted that, because of the interaction of developing creditor protection law and federal bankruptcy law, creditor protection may also be in some doubt for even residents of DAPT states for 10 years after a trust's creation. Generally, it does not matter to the IRS that such a creditor of the grantor exists. What matters to the IRS is that the grantor could create such a creditor who could attach the trust assets. However, many commentators believe that just because an unknown future creditor can reach a trust's assets, that should not make the trust a grantor trust under IRC Section 677. Whether or not the transfer to the trust is a "fraudulent conveyance" by the grantor to the trust under applicable state law may make a difference. However, many commentators argue that if the transfer is fraudulent as to possible future creditors only, applying the fraudulent conveyance doctrine would make it impossible to create any non-grantor trust until the statute of limitations on creditors reaching trust assets runs, and that cannot be the intention of IRC Section 677. *See* the discussion *infra* Section V.B.5.

Furthermore, in most of the PLRs, the settlor is not a beneficiary but is more accurately described as a potential appointee under a non-fiduciary limited power of appointment. INGs are not self-settled trusts. Under common law, a settlor being a mere potential appointee under a non-fiduciary power does not trigger self-settled trust status. Despite this, there are several reasons to use a DAPT statute. The Uniform Trust Code (UTC) opens up a dangerous window for debate since it does not foreclose *non-fiduciary* powers to appoint to a settlor as triggering the self-settled trust rule. Instead, it merely speaks to distributions that may be made.<sup>21</sup> Some UTC states have clarified that this rule does not apply when a settlor is a mere potential appointee under a non-fiduciary power.<sup>22</sup> Despite the common law rule, attorneys understandably prefer to use a belt-and-suspenders approach and all ING PLRs have used DAPT statutes. This is not just an issue of creditor protection, because if the IRS finds that the trust is accessible to the settlor's creditors, it would be a grantor trust.<sup>23</sup>

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<sup>20</sup> Treas. Reg. § 1.677(a)-1(d).

<sup>21</sup> Uniform Trust Code (UTC), §505(a)(2).

<sup>22</sup> E.g., Ohio R.C. §5805.06(B)(3)(a).

<sup>23</sup> Treas. Reg. § 1.677(a)-1(d).

There is another equally important reason to use a DAPT – whether the joint power holders (donees) of the lifetime power of appointment could be considered general power holders under state law, thus subjecting the ING to a *power holder's* creditors. There is a clear federal regulation that prevents the shrinking committee structure of the ING from being a general power for federal estate/gift tax purposes under Treas. Reg. § 25.2514-3(b)(2). However, state debtor/creditor law needn't follow federal tax law. An ING has a distribution committee who have the joint power to appoint all the trust assets to themselves. What if a power holder is sued? Most DAPT statutes foreclose this line of attack, and for this reason most ING Trusts are created under such a DAPT statute.

- (2) The presence of an adverse party does not prevent the application of IRC Section 673 to make a trust a grantor trust.

IRC Section 673 provides for grantor trust treatment if the settlor of a trust holds a reversionary interest in income or principal worth more than 5% of the trust's value at its inception. IRC Section 673(c) provides that discretionary powers should be assumed to be exercised to maximize the value in favor of the grantor “in determining whether a reversionary interest has a value in excess of 5%.”

However, until recently, this statutory language has not been interpreted to suggest that a discretionary exercise in favor of the grantor can be assumed in determining whether a reversion actually exists. While the term reversion is not defined in the statute, it has traditionally been defined by the IRS as the interest remaining with the owner of a vested estate upon transferring a lesser vested estate to another person. Under this definition, if a grantor has transferred his entire interest, and not a lesser interest, then IRC Section 673 should not apply even if the grantor could receive a distribution of trust property as a result of discretionary actions of others, whether or not those others are adverse parties. However, in PLR 201642019, the IRS revoked part of PLR 201426014 and held that under IRC Section 673(c), the subject trust was a grantor trust, because members could resign from a distribution committee, which under the terms of the trust would cause the trust to terminate and revert to the grantor. An IRC Section 673(c) “fix” for this IRS position might be to draft the trust to provide if such resignations occurred, the ING trust would continue without providing the trustee with any discretion to make distributions to the grantor.

- b. The ING trust also needs to be designed in a manner where certain retained powers by the grantor exist which will make the trust incomplete for gift tax purposes, but those retained powers must not make the trust a grantor trust.

For a gift in trust to be wholly incomplete for gift tax purposes, as to both its current and remainder interests, the grantor needs to retain controls over the current and future dispositions (including remainder dispositions) of the trust assets.

- (1) The grantor needs to retain a testamentary power of appointment over the remainder beneficiary interests of the trust.

However, retaining a testamentary power of appointment arguably only makes the transfer to the trust an incomplete gift with respect to the remainder. That retained power does not make the trust a grantor trust, provided the trust instrument does not provide for the accumulation of trust income for testamentary disposition by the grantor without the approval or consent of an adverse party. *See* IRC Section 674(b)(3); Treasury Regulations Section 1.674(b)-1(b)(3).

- (2) The grantor needs to also have powers that make the grantor's transfer to the trust incomplete for its current beneficiary interests.
  - (a) The grantor could have a retained power under which distributions could only be made from the trust with the consent of the grantor and the majority of a distribution committee.

The IRS position is that for gift tax purposes the distribution committee does not have a substantial adverse interest as to the grantor's exercise of that power. *See* Treas. Reg. §25.2511-2(e) and PLR 201310002. Interestingly, as noted above, the same distribution committee may be adverse for income tax purposes, if they have potential current interests.

- (b) The grantor could retain the sole power to make trust distributions from trust principal for the health, education, maintenance and support of his descendants.

Since such a power is a non-fiduciary power it makes the grantor's transfer incomplete for its current interests. *See* Treas. Reg. §25.2511-2(c) and PLR 201310002. However, that retained power does not make the ING trust a grantor trust for income tax purposes. *See* IRC Section 674(b)(5)(A).

- (3) Distribution committee members of an ING trust should avoid having a general power of appointment with the distribution powers that they have.

Otherwise, gift tax consequences for a member could occur if there is a release of a general power of appointment to allow a trust distribution to a beneficiary other than that member.

- (a) The statutory exception under IRC Section 2514(c)(3)(A) could apply to avoid gift tax consequences for distribution committee members when a distribution is made to a beneficiary other than that committee member.

Under that Section, a general power of appointment is not deemed to exist if the holder can only exercise the power in conjunction with the person who created the power.

- (b) The statutory exception under IRC Section 2514(c)(3)(B) could apply to avoid gift tax consequences for a distribution committee member when a distribution is made to a beneficiary other than that committee member.

Under that Section, a general power of appointment is not deemed to exist if the holder can only exercise the power in conjunction with a person who has a substantial interest which is adverse to the exercise of the power. This exception generally applies in the context of a distribution power by unanimous consent of a distribution committee because if a co-holder of the power dies the remaining members of the committee will have a less diluted power. *See* Treas. Reg. §25.2514-3(b)(2).

- (4) A state could interpret IRC Sections 671-677 differently than the IRS does, so that one or more of IRC Sections 671-677 apply to make the trust a grantor trust for state law purposes, or the state tax law could be inconsistent with federal law.
  - (a) For instance, a state may interpret IRC Section 673(c), or IRC Section 677, differently than the IRS does.

As noted above, creditors of a resident of a common law state may be able to attach the trust assets of a self-settled trust created in a DAPT state, which could make that trust a grantor trust under IRC Section 677. *See* the discussion *infra* Section III.F.3.a.(1).

- (b) State grantor trust statutes could operate differently in that state than the Internal Revenue Code does.

For instance, in 2014, New York state passed legislation providing that a non-grantor trust created by a New York resident which would ordinarily be exempt from New York tax under NY CLS Tax §605(b)(3)(D) because it has no New York trustees, assets in New York or New York source income, will be treated as a grantor trust for New York state income tax purposes if the trust meets both the following tests: (i) the trust does not qualify as a grantor

trust for federal purposes under IRC Section 671-679 and (ii) the grantor's transfer to the trust is treated as an incomplete gift. NY CLS Tax §612(b)(41).<sup>24</sup>

One solution for New Yorkers fearful of a future state capital gains tax event for one or more of their low basis assets is for them to consider contributing those assets to a trust located in a state that will not tax capital gains that qualifies as a QTIP trust. A QTIP trust is a completed gift but is not subject to gift taxes because of the operation of IRC Section 2523(f). That QTIP trust could be drafted to be taxed as a grantor trust for accounting income and a non-grantor trust for capital gains income. The QTIP should be designed to either prohibit a principal distribution (or at least a distribution of taxable gain) to the grantor's spouse, or require an adverse party's consent before a principal distribution could be made. In those states in which creditor protection is not affected, it would appear the spouse could be given a testamentary power of appointment, including a power to appoint back to a grantor. The fact that the trust is drafted to be a non-grantor trust for capital gains income will not make the trust a grantor trust for New York state income tax purposes under NY CLS Tax §612(b)(41), discussed in the preceding paragraph, because the transfer of assets to the trust is a completed gift for gift tax purposes.

This technique may also be a solution for taxpayers who live in high tax states other than New York to avoid high state capital gains taxes. It is easier to draft a trust, in which a grantor does not retain IRC Section 671-678 powers, if the grantor does not have to retain powers to make the trust an incomplete gift trust. It is true that the non-principal income of an *inter vivos* QTIP trust will be subject to the high tax state's income taxes, but that can be reasonably managed with the trust's asset class mix. For example, after the low basis assets are sold, the resulting sale proceeds could be invested in non-taxable bonds and/or low dividend paying stocks.

4. The overall cumulative federal revenue considerations of the techniques described *supra* in this Section III may lead Treasury to be more aggressive in protecting federal revenues.

To date, the IRS has been relatively benign in using the tools it has to prevent the creation of multiple non-grantor trusts, perhaps because that benign position generally did not affect federal revenues (in fact, in some cases those positions may have increased federal revenues). Because of the potential federal revenue loss identified above, the reader may conclude that benign IRS behavior may not continue. As noted, the IRS could use the tools of IRC Section 643(f) regulations and equitable tax doctrine (e.g., substance over form), to attack the creator of multiple trusts.

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<sup>24</sup> Although aimed primarily at New York resident trusts exempt under Tax Law 605(b)(3)(D), the statute is not confined to them. Even if a resident trust has a New York trustee and would therefore presumptively be subject to New York income tax, the rule applies to shift taxability to the grantor. This will be a rare case, as ING trusts are usually set up to conform to Tax Law 605(b)(3)(D).

A proposed regulation under IRC Sec. 643(f) was issued along with proposed regulations under IRC Sec. 199A. Prop. Reg. §1.643(f)-1 would have clarified and strengthened the statute with a definition of “a principal purpose” and two examples illustrating when trusts have substantially identical beneficiaries. The final version of the regulation in Treas. Reg. §1.643(f)-1 was shortened and the definition and examples were eliminated, so the final regulation does little more than repeat the statute. Part VIII of TD 9847 (2/4/2019) states:

Based on the comments received, the Treasury Department and the IRS have removed the definition of “principal purpose” and the examples illustrating this rule that had been included in the proposed regulations, and are taking under advisement whether and how these questions should be addressed in future guidance. This includes questions of whether certain terms such as “principal purpose” and “substantially identical grantors and beneficiaries” should be defined or their meaning clarified in regulations or other guidance, along with providing illustrating examples for each of these terms.

The “future guidance” has not been issued. Even if the IRS gets more aggressive in its enforcement, the taxpayer may still be able to create several non-grantor trusts that are not ING trusts, as long as the creator of those trusts complies with potential IRC Section 643(f) enforcement or equitable tax doctrine (e.g., “substance over form”) enforcement.

#### IV. SOME OF THE BEST CREATIVE TAX PLANNING TECHNIQUES FOR GRANTOR TRUSTS.

##### A. Conventional Uses of Grantor Trust Status.

###### 1. Gift tax free payment of income tax.

For wealthy individuals, perhaps the most powerful feature of grantor trusts is that they permit the grantor to pay income taxes on trust income, without the payment of those taxes being treated as a gift for gift tax purposes.<sup>25</sup> The grantor trust can earn tax-free returns during the grantor’s lifetime, even as the grantor’s own estate is depleted by the payment of income taxes. The combination of (a) tax-free growth for beneficiaries and (b) depletion of the grantor’s personal estate often produces a dramatic transfer of wealth from the grantor to the trust. If the trust passes outside of the grantor’s estate for estate tax purposes, the wealth that is effectively shifted through grantor trust status is never taxed by the estate and gift tax system.

###### a. Mismatch between gift and estate tax completion and income tax ownership.

The opportunity to shift wealth through the grantor’s payment of income taxes on grantor trust income arises because of a mismatch between the grantor trust rules, on the one hand, and the rules governing gift completion and gross estate inclusion, for gift and estate tax purposes, on the other. In particular, it is possible for a grantor to make a completed gift to a trust that will

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<sup>25</sup> Rev. Rul. 2004-64.

pass outside of the grantor's gross estate for estate tax purposes, yet still cause the trust to be treated as owned by the grantor for income tax purposes.<sup>26</sup>

- b. IRS position on payment of income tax. In Rev. Rul. 2004-64, the IRS conceded that the payment of income taxes on the income of a grantor trust is not a gift for gift tax purposes. In so ruling, the IRS abandoned the position that the payment of income taxes, at least in some circumstances, could be treated as a taxable for gift tax purposes.<sup>27</sup>
  - (1) Rev. Rul. 2004-64. The position of Rev. Rul. 2004-64 is sound for at least two reasons. First, a gift for gift tax purposes requires some voluntary act,<sup>28</sup> which is missing where the grantor is required by law to pay tax. Second, a gift is a transfer of property for less than adequate and full consideration in money or money's worth. When the grantor of a trust pays income tax on trust income, his or her transfer of funds to the revenue collector is in exchange for the extinguishment of the grantor's obligation for the amount of the tax paid.
  - (2) Is there a possible risk if grantor controls grantor trust strings? Perhaps the grantor does make a voluntary transfer (in the form of payment of income taxes) if the grantor controls whether a trust is a grantor trust or not, such as where the only grantor trust "string" is the grantor's power to substitute assets of equivalent value under IRC Section 675(4)(C). So long as Rev. Rul. 2004-64 is in force, however, this argument is foreclosed to the IRS.<sup>29</sup>

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<sup>26</sup> See generally Bramwell and Vara, "Basis of Grantor Trust Assets at Death: What Should Treasury Do?" 160 Tax Notes 793 (August 6, 2018).

<sup>27</sup> Cf. PLR 9444033, modified by PLR 9543049

<sup>28</sup> *Estate of DiMarco v. Comm'r*, 87 T.C. 653, 658 (1986) ("[Taxpayer] never made a taxable gift of any property interest in the survivor's income benefit because we find no act by decedent that qualifies as an act of 'transfer' of an interest in property"), acq. in result, 1990-2 C.B. 1; *see also Harris v. Comm'r*, 340 U.S. 106, 115 (1950) ("[A] gift tax is an exaction which does presuppose the voluntary transfer of property and not a transfer in obedience to law") (Frankfurter, J., dissenting);

<sup>29</sup> *See Rauenhorst v. Comm'r*, 119 T.C. 157, 170-71 (2002) ("[The IRS] may not ... litigate against the officially published rulings of the Comm'r without first withdrawing or modifying those rulings.").

2. Tax-free swapping out of low-basis assets.

Another commonly exploited advantage of grantor trust status is that it permits the grantor to transact with a trust without income tax consequence.<sup>30</sup> For example, the grantor may transfer cash or high-basis assets to the grantor trust in exchange for low-basis assets. The grantor may then die holding the low basis assets, which will qualify at death for a step up in basis under IRC Section 1014(a).<sup>31</sup> At the same time, when grantor trust status terminates at the grantor's death, the trust will hold the cash or high-basis assets, even though the trust's property may pass outside the grantor's estate for estate tax purposes.

a. Ensuring there are no gift tax implications with a swap.

An exchange of assets between the grantor and another party, such as a swap of low-basis assets from a grantor trust in exchange for cash or high-basis assets, is not a gift for gift tax purposes, if the exchange is for full and adequate consideration in money or money's worth.<sup>32</sup> Thus, if the fair market values in the exchange are identical, the transfer will not be a taxable gift.

(1) Ensuring full and adequate consideration.

It is good practice for the grantor and the grantor trust to enter into a binding contract which obligates the grantor to pay an amount equal to the full fair market value of the property transferred to the grantor.

(2) IRS safe harbor on retained power of substitution.

If the grantor swaps assets pursuant to a power of substitution described in IRC Section 675(4), the trust instrument, in order to comply with an IRS safe harbor against gross estate inclusion under IRC Sections 2036, 2038, and 2042,<sup>33</sup> may require the grantor to certify and the trustee to confirm that the substituted assets acquired are of equivalent value.

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<sup>30</sup> See, e.g., Rev. Rul. 85-13.

<sup>31</sup> Section 1014(a) generally provides that property acquired or passing from a decedent receives a basis equal to its fair market value on the date of the decedent's death or the alternate valuation date, if the Section 2032 estate tax alternate valuation date election is made. As most property tends to appreciate, and well-advised taxpayers typically realize losses before death, the fresh basis at death under section 1014(a) is commonly referred to, including in this outline, as a basis "step-up."

<sup>32</sup> IRC § 2512(b); Treas. Reg. § 25.2511-1(g); Treas. Reg. § 25.2512-8.

<sup>33</sup> Rev. Rul. 2008-22; Rev. Rul. 2011-28.

- b. IRS position that grantor activities with grantor trusts are also ignored.

The ability to swap assets tax free is made possible by the well-entrenched IRS position, set forth in Rev. Rul. 85-13, that a grantor trust is ignored for income tax purposes and does not “retain its vitality as a separate entity.”<sup>34</sup> Since Rev. Rul. 85-13, the IRS has emphatically reiterated that the grantor is the owner of grantor trust assets for all income tax purposes and has applied the principle in a wide variety of contexts.<sup>35</sup> On one occasion, the IRS even held that a grantor trust is ignored for purposes of an excise tax.<sup>36</sup> Treas. Reg. § 1.1001-2(c) Example 5, which provides the grantor of a grantor trust “is treated as the owner of the entire trust,” apparently gives the position of Rev. Rul. 85-13 the force of law.<sup>37</sup>

Sales and purchases by a grantor of a grantor trust are disregarded for income tax purposes even when the grantor does not have any rights or powers with respect to the corpus of the trust, but does have rights or powers with respect to the income of the trust. *See* IRC Section 677.

If there are any exceptions to the principle that grantor activities with grantor trusts are ignored, they are few and narrow.<sup>38</sup>

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<sup>34</sup> Rev. Rul. 85-13; *but see Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984), non-acq. 1985-7 IRB 28.

<sup>35</sup> *See, e.g.*, Rev. Rul. 88-103 (involuntary conversions under section 1033); Rev. Rul. 2004-86 (tax-free exchanges under section 1031); Rev. Rul. 2008-13 (transfers of life insurance for value under Section 101); PLR 9152011 (exemption from tax on interest income under Section 871(i)); PLR 200104005 (exclusion of gain from the sale of a residence under Section 121); PLR 9031022 (characterization of interest under sections 163(h) and 469); PLR 9141046 (non-taxable acquisition of qualified replacement property under Section 1042).

<sup>36</sup> Rev. Rul. 87-61.

<sup>37</sup> Though Treas. Reg. § 1.1001-2(c) Example 5 was issued before Rev. Rul. 85-13 was published, it effectively established by regulation the position in an earlier ruling, Rev. Rul. 77-402, which also states that the grantor of a grantor trust is “the owner of all the trust property for Federal income tax purposes.” That said, the theory that a grantor’s activities with a grantor trust are indeed ignored for income tax purposes was rejected by the Second Circuit in *Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984), non-acq. 1985-1 C.B. 184.

<sup>38</sup> *See* Prop. Treas. Reg. § 1.108-9(c)(1), (2) (cancellation of indebtedness rules only apply if the grantor, not the grantor trust, is bankrupt or insolvent); T.D. 9829 (declining to expand definition of eligible partner to include grantor trusts for purposes of Section 6221(b), concerning partnership audits); PLR 200920031 (holding that gain is recognized by the grantor upon an in-kind satisfaction of a charitable annuity by a charitable lead annuity trust, despite that it was a grantor trust for income tax purposes, and distinguishing Rev. Rul. 55-410, which holds that gain is not recognized by an individual upon satisfying a charitable pledge obligation in kind). In addition, the rules in Section 1361 limiting the persons eligible to hold shares in S corporations provide an example of a statutory exception to the general treatment of a grantor trust as sharing an identity with its grantor. Section 1361(c)(2)(A)(i) permits a trust to hold shares in an S corporation if it is a grantor trust but only if it is owned by a single taxpayer and that taxpayer is a U.S. citizen or resident. If the grantor trust were ignored for purposes of these rules, each grantor of a grantor trust with multiple owners would be treated as the owner of the stock owned by the trust and, if U.S. citizens or residents, would be treated as eligible shareholders. Similarly, under Section 1361(c)(2)(A)(v), an electing small business trust (an “ESBT”) is an eligible shareholder. If the ESBT is also a grantor trust treated as owned by a nonresident alien, the trust is an eligible shareholder notwithstanding Section 1361(b)(1)(c)’s general prohibition against nonresident alien shareholders.

- c. A grantor of a grantor trust, by the grantor swapping assets with the grantor trust, can create basis enhancing opportunities.

Swapping out low basis assets achieves a basis step up artificially. Indeed, the artificial step up is more favorable than the IRC Section 1014(a) change of basis. IRC Section 1014(a) generally imposes a fresh basis at death equal to the fair market value of property on the date of the decedent's death or the alternate valuation date, if an IRC Section 2032 alternate valuation date election is made. Thus, if property has declined in value, IRC Section 1014(a) may cause a step down in basis rather than a step up. The grantor of a grantor trust can avoid this adverse result by swapping out only the appreciated assets, and leaving in trust any property with a basis that is higher than fair market value in the hands of the trust, so that the inherent loss is (presumably) preserved.

### 3. Tax-free freeze transactions.

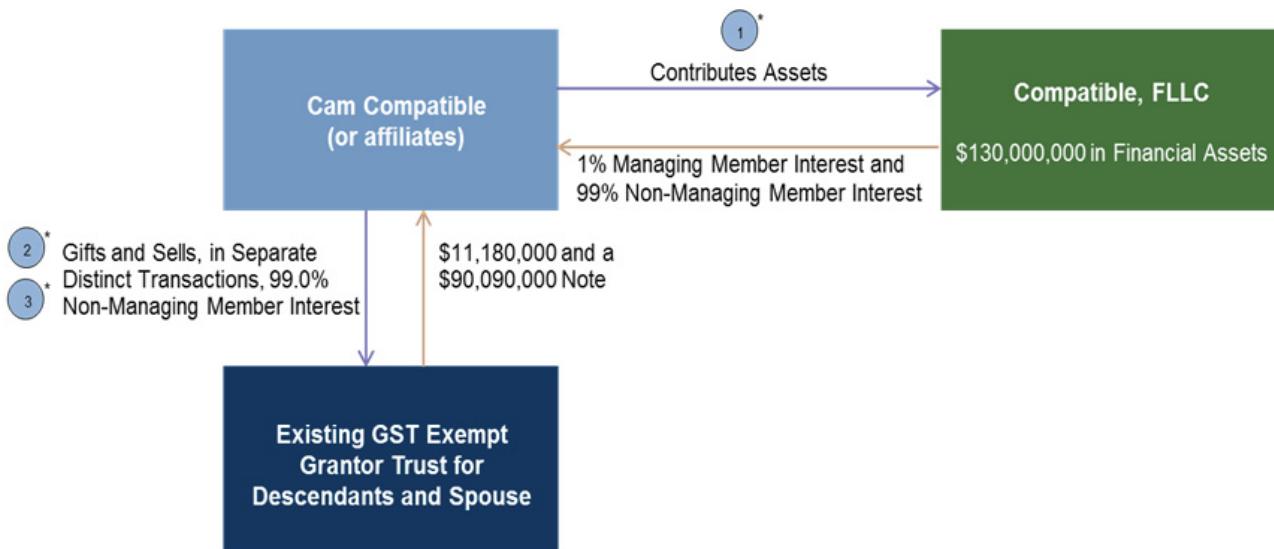
A final conventional use of grantor trusts is to enter into tax-free transactions that have the effect of shifting value, including future investment returns, from the grantor to the grantor trust.

- a. If the grantor sells a low basis asset to a grantor trust (the “SIDGT” technique), the taxpayer will pay less estate tax, because his estate is liable for the income taxes and health care taxes associated with that sale. A trust that does not pay income taxes and health care taxes will grow much faster than a trust that does pay income taxes and health care taxes. Any growth by the grantor trust’s assets will escape future estate taxes. Stated differently, depending on one’s tax perspective, when a taxpayer uses the SIDGT technique, that taxpayer is using income taxes and health care taxes to subsidize the payment of transfer taxes or vice versa.

Consider the following example:

*Example 4: Cam Compatible Creates a Grantor Trust for the Benefit of His Spouse and Family and Makes Certain Sales to That Trust (“SIDGT”) Technique*

*Cam Compatible owns \$150,000,000 in financial assets. Cam and affiliates contribute \$130,000,000 to a family limited liability company (“FLLC”) (Transaction 1). In a separate and distinct transaction (Transaction 2) Cam contributes \$11,180,000 to a trust that is a grantor trust for income tax purposes. The trust treats his wife, Carolyn, as the discretionary beneficiary and gives her certain powers of appointment over the trust. Cam, at a much later time (Transaction 3), sells non-managing member interests to that trust, pursuant to a defined value allocation formula, in consideration for cash and notes. Assuming a 30% valuation discount, the technique is illustrated below.*



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

If the considerations that are noted below can be addressed, this technique would provide significant flexibility to both Cam and Carolyn in making sure their consumption needs are met in the future and, depending upon the terms of the powers of appointment that Cam gives Carolyn, could provide the flexibility that they need to address any changing stewardship goals that may accrue.

- (1) Income tax and basis enhancing advantages of the SIDGT technique.
  - (a) The ability to have sales to a grantor trust be ignored for income tax purposes.

As noted above, if the grantor is treated as the owner of the trust property and transfers property into the trust in exchange for property previously held by the trust, such transfer will not be recognized as a sale, exchange or disposition for federal income tax purposes.<sup>39</sup> Thus, no gain or loss is realized by the grantor or the trust. The basis of the property transferred into the trust is unaffected by the transfer, and neither the grantor or the trust acquires a cost basis in the assets transferred from or to the trust.

Also as noted above, it is possible to design a grantor trust that is defective for income tax purposes (e.g., a retained power to substitute assets of the trust for assets of equivalent value), but is not defective for transfer tax purposes. In comparison to discounting or freezing a client's net worth, over periods of 20 years or more, the effect of paying the income taxes of a grantor trust is generally the most effective wealth transfer technique.

<sup>39</sup> See PLR 9010065 (Dec. 13, 1989).

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- (2) The advantage of locating income tax inefficient asset classes inside a grantor trust that is not subject to estate taxes.
  - (a) The technique of asset class location in order to improve the after-tax, after-risk adjusted rate of return for an investment portfolio more level.

In order to optimize after-tax risk-adjusted returns, wealth management for the private taxable investor involves: (i) the creation of tax advantaged entities; (ii) the investment in asset classes that produce an optimal after-tax risk-adjusted return; and (iii) asset class location in different tax advantaged entities.

Certain asset classes that may optimize risk-adjusted returns may not be income tax efficient, which could produce a less than optimal after-tax risk adjusted return for the private investor, unless the technique of locating those asset classes in estate tax protected grantor trusts is used.

Stated differently, not every asset class that an investor and the investor's family would desire in their collective investment portfolios in order to reduce the portfolio's risk, or volatility, lends itself to investment via a tax efficient low turnover fund (i.e., a broad based passive equity fund). For instance, asset classes such as high yield bonds, hedge funds, master limited partnerships, emerging market debt and various forms of private equity are not available in a passive, low turnover (tax efficient) product. An investor and his family may have all of those asset classes in their collective portfolios.

Location of tax inefficient investment classes in a grantor trust significantly ameliorates the income tax inefficiencies of those classes, because transfer taxes are saved when the grantor pays the income taxes of the trust. Engaging in an asset class location strategy of locating income tax inefficient asset classes in grantor trusts, and other family planning vehicles, may greatly ameliorate those tax inefficiencies and lead to an optimal after tax risk adjusted return for the private investor. There exist various techniques for the investor to have direct, or indirect, access to these tax efficient entities. There exist various techniques for the investor to create these tax efficient entities without paying gift taxes.

Table 3 below illustrates the annual growth required for an equity fund to double (after both income taxes and transfer taxes) for an investor's beneficiaries, if the investor dies in 10 years, depending upon how a fund is located (also *see* attached Schedule 3). This table also illustrates the significant wealth management advantages for the private investor who: (i) engages in estate planning; (ii) invests income tax efficiently for those asset classes that he can; and (iii) optimizes location of tax inefficient asset classes in estate tax protected grantor trusts to ameliorate income tax inefficiencies.

Table 3

|  |  | Annual Growth Rate Required on a \$1mm Equity Fund Which Has a 2% Dividend Rate to Achieve \$2mm (After Tax) for Investor's Beneficiaries for an Investor Who Dies in 10 Years <sup>(1)</sup> , Depending Upon How a Fund is Located, and Percentage Improvement to Equal Equity Fund with 5% Turnover <sup>(2)</sup> , 20% Turnover <sup>(3)</sup> or 50% Turnover <sup>(4)</sup> |        |   |        |        |   |                            |       |  |        |        |   |        |        |  |                       |        |  |       |       |        |        |        |       |       |       |       |
|--|--|--|--------|---|--------|--------|---|----------------------------|-------|--|--------|--------|---|--------|--------|--|-----------------------|--------|--|-------|-------|--------|--------|--------|-------|-------|-------|-------|
|  |  | No Estate Planning Fund Owned by Investor  |        |   |        |        |   | Estate Planning Techniques |       |  |        |        |   |        |        |  | Fund Owned by Charity |        |  |       |       |        |        |        |       |       |       |       |
| Equity Fund's Annual Turnover of Assets                          | Fund is Owned by Investor and Investor's Estate is Not Subject to Estate Tax Because of Existing Exemptions and/or Charitable Bequests |  |        | Fund is Owned by Investor and is Fully Taxable in the Investor's Estate |        |        | Fund is in a Grantor Trust and Grantor Buys the Assets from the Grantor Trust for Cash Shortly Before Grantor's Death |                            |       | Fund is in a Grantor Trust at Investor's Death and Remaining Unrealized Income is Taxed in 10 Years Before Grantor's Death |        |        | Fund is in a Grantor Trust at Investor's Death and Remaining Unrealized Income is Taxed in 10 Years After Grantor's Death |        |        | Fund is Held in a Non-Grantor Trust and Remaining Unrealized Income is Taxed in 10 Years |                       |        | Fund is Not Subject to Income Taxes or Estate Taxes Because Fund is Owned by a Charity |       |       |        |        |        |       |       |       |       |
|  | A  |  |        | B   |        |        | C   |                            |       | D  |        |        | E   |        |        | F  |                       |        | G  |       |       |        |        |        |       |       |       |       |
|  | (2)  | (3)  | (4)    | (2)   | (3)    | (4)    | (2)   | (3)                        | (4)   | (2)  | (3)    | (4)    | (2)   | (3)    | (4)    | (2)  | (3)                   | (4)    | (2)  | (3)   | (4)   |        |        |        |       |       |       |       |
| Indexed Fund with 5% Annual Turnover <sup>(5)</sup>              | 5.94%  | NA   | NA     | NA  | 11.78% | NA     | NA  | NA                         | 5.63% | NA   | NA     | NA     | 6.16%   | NA     | NA     | 6.58%  | NA                    | NA     | 5.97%  | NA    | NA    | 5.18%  | NA     | NA     | NA    |       |       |       |
| Active Beta Indexed Fund with 20% Annual Turnover <sup>(6)</sup> | 6.64%  | 11.72%   | NA     | NA  | 13.08% | 10.67% | NA  | NA                         | 6.00% | 6.57%  | NA     | NA     | 8.31%   | 25.1%  | NA     | NA   | 8.51%                 | -1.08% | NA   | NA    | 7.29% | 4.64%  | NA     | NA     | 5.18% | 0.00% | NA    | NA    |
| Equity Fund with 50% Annual Turnover <sup>(7)</sup>              | 7.50%  | 26.27%   | 13.02% | NA  | 14.80% | 25.60% | 13.26%  | NA                         | 6.41% | 13.94%   | 6.91%  | NA     | 6.53%   | 6.05%  | 3.46%  | NA   | 6.58%                 | 0.09%  | 1.18%  | NA    | 7.77% | 11.55% | 6.61%  | NA     | 5.18% | 0.00% | 0.00% | NA    |
| Equity Fund with 200% Annual Turnover <sup>(8)</sup>             | 9.55%  | 60.75%   | 43.89% | 27.31%  | 19.04% | 61.62% | 45.76%  | 28.67%                     | 7.23% | 28.58%   | 20.64% | 12.65% | 7.23%   | 17.47% | 14.59% | 10.76%   | 7.23%                 | 10.00% | 11.20%   | 9.89% | 9.55% | 37.08% | 31.01% | 22.89% | 5.18% | 0.00% | 0.00% | 0.00% |

(1) These calculations ignore the effect of investment management fees, state income taxes and investment advisor costs. These calculations assume the estate planning vehicles are created without paying gift taxes. An equity fund owned by a tax exempt entity would need 5.18% annual growth rate of return over 10 years, assuming a 2% dividend rate, to achieve \$2mm.

(2) % annual improvement necessary to equal fund with 5% annual turnover.

(3) % annual improvement necessary to equal fund with 20% annual turnover.

(4) % annual improvement necessary to equal fund with 50% annual turnover.

(5) 100% short-term realized gains in year 1, 0% short-term realized gains and 100% long-term realized gains in years 2-10.

(6) 10% short-term realized gains in year 1, 10% short-term realized gains and 90% long-term realized gains in years 2-10.

(7) 10% short-term realized gains in year 1, 25% short-term realized gains and 75% long-term realized gains in years 2-10.

(8) 100% short-term realized gains in years 1-10.

The asset location of a tax inefficient investment is particularly important. There is a much more modest differential on what is needed to earn pre-tax for a tax inefficient investment, in comparison to a tax efficient investment, in order to double the investment over a 10-year period, if the investment is located in an estate tax protected grantor trust, as opposed to being taxed in the taxpayer's estate. For instance, if a fund is located in an estate tax protected grantor trust, and if the remaining unrealized income is taxed after the grantor's death, a 100% turnover fund (e.g., certain hedge funds) needs to earn 7.23% before taxes to double the value of the investment after taxes in 10 years and a 5% turnover fund (e.g., S&P 500 index fund) needs to earn 6.58% before taxes to double the investment after taxes in 10 years. See Column E in above Table 3. Stated differently, a 10% improvement in annual pre-tax return is necessary for a 100% turnover fund to equal a 5% annual turnover fund, if the fund is located in a grantor trust and if the remaining unrealized income is taxed after the grantor's death (see column E (2)). Contrast this result with those same funds being held in the taxpayer's estate, if those same types of funds are subject to estate taxes. If the funds are subject to estate taxes, a 5% turnover will need to annually earn 11.78% before taxes to double the investment after taxes in 10 years, and the high 100% turnover fund will need to annually earn 19.04% before taxes to double the investment after taxes in 10 years. See Column B. A 61.62% annual pre-tax improvement in return is necessary for a 100% turnover fund to equal a 5% annual turnover fund, if the fund is fully taxable in the investor's estate (see column B (2)). The difference between 10% annual pre-tax

needed improvement and 61.62% annual pre-tax needed improvement is obviously significant in determining where to locate a 100% turnover fund.

Similarly, Table 4 below illustrates, if the investor dies in 10 years, the annual interest required for a bond fund to grow by one-third after-tax, depending where a fund is located, and whether the fund interest is tax-free (*also see* attached Schedule 4).

**Table 4**

| Type of Bond Investment Fund | No Estate Planning Fund is Owned by Investor                            |        | Estate Planning Techniques (Fund is Not Subject to Estate Taxes) |        |   |        |
|------------------------------|---|--------|--|--------|---|--------|
|                              | Fund is Owned by Investor and is Fully Taxable in the Investor's Estate |        | Fund is Held in a Grantor Trust at Investor's Death              |        | Fund is Held in a Non-Grantor Trust; or Fund is Owned by Investor and Investor's Estate is Lower than Remaining Estate Tax Exemption; or a Bequest of Fund is Made to Charity at Investor's Death |        |
|                              | A   |        | B  |        | C   |        |
|                              | (1)   | (2)    | (1)  | (2)    | (1)   | (2)    |
| Tax Free Bond Fund           | 8.40%   | N/A    | 3.00%  | N/A    | 3.00%   | N/A    |
| Taxable Bond Fund            | 14.19%  | 68.92% | 3.97%  | 32.42% | 5.07%   | 68.92% |

(b) Location of tax inefficient classes in a grantor trust and managing the grantor trust through substitution strategies, further enhances the after tax advantage of a low turnover index fund.

As Column C (1) in Table 4 demonstrates the lowest pre-tax rate of return that is required to more than double the fund assets after 10 years is 5.65%, if a low turnover fund (e.g., a 5% turnover fund) is held in a grantor trust and if cash is substituted for the fund before the grantor's death. This is a classic example of the synergistic power of estate planning when it is coupled with a basis enhancing strategy.

(3) Consideration of swapping out low-basis assets that are sold to a grantor trust.

(a) The grantor may not have any high basis assets, or cash, to swap.

If that is the case, consider a recourse third party loan of cash to the grantor from a third party lender. The grantor could then use that cash to swap for the low basis asset. The grantor trust may then be converted to a complex non-grantor trust. At a later time, in an independent transaction, the grantor could borrow the high basis cash from the trust with a long-term, recourse note that is unsecured and use that cash to pay the principal of the third party loan. This lending strategy is discussed in further detail *infra* Section IV.A.3.a.(13)(d).

(b) To the extent, after the swap of assets, “swapped” low basis assets grow more than the “swapped” high basis assets in the grantor trust, the grantor’s estate taxes will increase.

(4) Transfer tax advantages of the SIDGT technique.

(a) Transfer tax advantage of transferring a non-managing interest.

The value of the non-managing interest is what a hypothetical buyer would pay a hypothetical seller assuming the parties are not related to each other and neither party is under an obligation to buy or sell. If they do not have any put rights, there may be a marketability discount in valuing the transferred interest. If the transferred interest does not have any inherent management rights, there may be a lack of control or minority discount in valuing the transferred interest.

(b) The near term death of the grantor of a grantor trust generally does not affect the technique like the death of a grantor of a GRAT.

If the grantor dies shortly after the sale to the grantor trust, all that should be included in the grantor’s estate is the remaining principal value of the note, assuming the sale is recognized as a valid sale and the note is recognized as a valid note. The grantor/seller could bequeath that note to his spouse. Over the surviving spouse’s lifetime, that surviving spouse could live off of the proceeds of the interest and principal payments of the note, before drawing down on any beneficial interest that surviving spouse would be entitled to under the trust. Thus, there are two lifetimes to utilize to assure the efficacy of the technique: the original grantor’s lifetime and his spouse’s lifetime.

(c) The appreciation of the assets of the trust above the interest of the note used in any sale to a grantor trust for the grantor’s spouse will not be taxable in the grantor/seller’s estate.

Assuming there is appreciation of the trust assets above the interest carry on any note that appreciation will not be subject to estate taxes in either the grantor’s estate or the grantor spouse’s estate. This is a significant transfer tax advantage. In calculations that we have performed in situations in which the joint life expectancies exceed 20 years, this is the second biggest driver of transfer tax savings for a client’s family. (The most important driver, mentioned above, for saving transfer taxes is the donor’s paying the income taxes of the trust on a gift tax-free basis.) The interest on the note does not have to be any higher than the applicable federal rate in order to ensure there are no gift tax consequences. *See* IRC Section 7872. The applicable federal rate, depending upon the length of the term of the note is equal to the average Treasury’s securities for that term. *See* IRC Sections 7872 and 1274(d).

## (5) Flexibility advantages of the SIDGT.

- (a) Flexibility could be achieved by naming a spouse as a beneficiary of the grantor trust and giving a grantor's spouse a special power of appointment.

It is possible for the patriarch or matriarch to name his or her spouse as a beneficiary of a trust and also give that spouse the power to redirect trust assets that are different than the default provisions of the trust instrument. IRC Section 2041 of the Internal Revenue Code provides that a person may be a beneficiary of a trust and have a power of appointment over the trust as long as the beneficiary does not have the right to enjoy the benefits of the trust under a standard that is not ascertainable and does not have the power to appoint the trust assets to either the beneficiary's estate or creditors of the beneficiary's estate. If an independent third party is trustee of the trust, that third party could have significant additional powers over the trust to distribute assets of the trust for the benefit of that spouse. If the spouse is serving as trustee and has distribution powers in that capacity, the distributions powers must be ascertainable and enforceable by a court for the health, education, maintenance standard of IRC Section 2041 of the Internal Revenue Code.

If unanticipated consumption problems accrue during a couple's lifetime and if the trust allows distributions to be made to meet those unanticipated consumption needs, that trust can obviously act as a safety valve for those needs. If the trust allows the grantor's spouse to appoint properties in a manner different than the default provisions of the trust, those powers of appointment could also serve as a safety valve to redirect the properties of the trust that is more consistent with the client's future stewardship goals.

A collateral benefit of the inherent flexibility of creating trusts that have the safety valve of having a client's spouse as the beneficiary, and giving that spouse a limited special power of appointment, is that the technique encourages the client to create such a trust when the client may be reluctant to do so.

- (b) Flexibility could also be achieved by converting the note to a note with a different interest rate, a private annuity, purchasing assets owned by the trust and/or renouncing the powers that make the trust a grantor trust.

The note retained by the grantor could also be structured and/or converted to meet the grantor's consumption needs, without additional gift taxes, as long as the restructuring is for adequate and full consideration. For instance, the note at a future time could be converted to a private annuity to last the grantor's lifetime. That conversion should be on an income tax free basis since, as noted above the trust and any consideration received for any sale to the trust are ignored for income tax purposes. The note could also be restructured to pay a different interest rate, as long as the new rate is not lower than the AFR rate or higher than the fair market value rate. If the grantor cannot afford to pay the trust's income taxes in the future, the trust could be converted to a complex trust that pays its own income taxes. However, converting the trust to a

complex trust could have income tax consequences if the then principal balance of the note is greater than the basis of the assets that were originally sold. That difference will be subject to capital gains taxes.<sup>40</sup>

(c) A donor, under the SIDGT technique (coupled with a transfer of an entity interest in which the donor has investment control), may retain investment control of the family's assets and may also retain limited control of any distributions from the transferred entity interests to family members, if that limited control is compliant with IRC Section 2036(a)(2).<sup>41</sup>

A donor, under the SIDGT techniques, may retain investment control of the family's assets and may also retain limited control of any distributions from the transferred entity interests to family members, if that limited control is compliant with IRC Section 2036(a)(2) and IRC Section 2038. The holding of *Powell v. Comm'r*, 148 TC 18 (2017) needs to be considered. That case held, if there is not a substantive non-transfer tax reason for the creation of the partnership,<sup>42</sup> that a decedent's right to amend a limited liability agreement and/or terminate the agreement, with the consent of all other partners, was a retained interest within the meaning of IRC Section 2036(a)(2). It should be noted that many commentators have criticized that holding because it is inconsistent with Supreme Court case law and other authorities. The Supreme Court held in *Helvering v. Helmholtz*, 295 U.S. 93 (1935), that a joint power to alter beneficial enjoyment, amend an agreement or terminate an agreement is not sufficient to produce inclusion in the gross estate if it merely reproduces rights already available under applicable state law. Therefore, the *Powell* holding that the partners' collective right to terminate the partnership agreement by unanimous agreement resulted in estate taxation under IRC Sections 2036 or 2038 may be in error because under state law partners always have that right.<sup>43</sup> A detailed discussion of *Powell* and steps for minimizing risk of gross estate inclusion of entity assets is beyond the scope of this paper.

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<sup>40</sup> See Treas. Reg. § 1.1001-2(e), Ex. 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 722.

<sup>41</sup> A thorough discussion of steps that need to be taken to avoid IRC Section 2036(a)(2) by a taxpayer is beyond the scope of this paper. See S. Stacy Eastland, "The Art of Donating Your Cake to Your Family and Eating It Too: Current Gift Planning Opportunities Using Strings That Are Not Considered Attached by the Donor" 47<sup>th</sup> Annual Heckerling Institute on Estate Planning ¶ 602.1 (June, 2013).

<sup>42</sup> See the discussion *supra* Section II.2.d.(3)(c). for a list of potential non-transfer tax reasons for the creation of a family limited partnership (FLP) or a family limited liability company (FLLC).

<sup>43</sup> See also *Tully Estate v. Comm'r*, 528 F.2d 1401 (Ct. Cl. 1976).

## (6) State income tax considerations.

Many states have a state income tax, but not all have similar provisions to the federal tax law with respect to grantor trusts. It is not clear that all states which respect grantor trust status would follow the logic of Rev. Rul. 85-13. Thus, there could be state income tax consequences with the sale, whether there are capital gains consequences and/or there could be a mismatch of the interest income and interest deduction associated with any sale.

## (7) The IRS could be successful in the argument, that because of the Step Transaction Doctrine, a valuation discount is not appropriate in valuing the transferred entity interest.

The equitable tax doctrine known as the step transaction doctrine, which is an application of the larger substance over form doctrine, could under certain circumstances, be used by the IRS to deny the tax benefit of taking a valuation discount on the sale of the partnership interest to the grantor trust as illustrated in this Example 4.<sup>44</sup> In applying the step transaction doctrine, the IRS or court may not treat the various steps of the transfer as independent. Instead, the steps in creating the partnership and transferring a partnership interest may be collapsed into a single transaction. Under the circumstances of creating the partnership and selling an interest to a grantor trust in the SIDGT technique, or the gift of the FLLC interest in the LAIDGT technique, the crucial key to not run afoul of the step transaction doctrine may be establishing that the creation of the FLP or FLLC should stand on its own. Could the act of a transferor creating a FLP or FLLC be independently separated from the gift and/or sale to the trust? The creation of the FLP or FLLC should be designed to be sufficiently independent on its own and as an act that does not require a gift and/or sale to that trust. There does not have to be a business purpose for the creation of the trust. It is difficult for this writer to understand the business purpose of any gift. As noted above, the Supreme Court has said on two separate occasions, estate and gift tax law should be applied in a manner that follows a state property law analysis.<sup>45</sup> Thus, the key questions could be, is the creation of the FLP or FLLC recognized for state property law purposes, and is its creation independent of any other events, including the subsequent gift and/or sale to the trust? It would seem to this writer in many situations it could be demonstrated that the creation of the trust did not require a gift and/or sale to that trust of the interest in the FLP or FLLC for state law property purposes or for tax purposes. Furthermore, as noted above, a sale or gift of an interest in a leveraged entity to such a trust should have an economic risk/reward to the trust. The value of the assets could depreciate below the value of the note. Depending upon the size of the transaction, 10% equity may represent real risk in comparison to the reward of the leverage. One percent equity may not. A detailed discussion of strategies and best practices for ensuring that discounts will be upheld against attack under the Step Transaction Doctrine is outside the scope of this paper.

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<sup>44</sup> See Donald P. DiCarlo, Jr., "What Estate Planners Need to Know About the Step Transaction Doctrine," 45 Real Prop. Tr. & Est. L.J. 355 (Summer 2010).

<sup>45</sup> See *United States v. Bess*, 357 U.S. 51 (1958); *Morgan v. Commissioner*, 309 U.S. 78 (1940).

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- (8) If the assets decrease in value, the gift tax exemption equivalent may not be recoverable.

If a trust's assets decrease in value, the gift tax exemption equivalent is not recovered unless the trust assets can be pulled back into the gross estate at death. Consequently, it is almost always advisable to include provisions that make it possible to toggle on gross estate inclusion, should that be desirable.<sup>46</sup>

- (9) There may be gain recognition considerations with respect to the note receivable or note payable that may exist with the grantor trust as the death of the donor, but not with the LAIDGT technique (see *infra* Section IV.A.3.a.(12)(b) for a discussion of the LAIDGT technique).

Under the facts of Revenue Ruling 85-13, a grantor of a trust purchases all of the assets of that trust in consideration for an unsecured promissory note. The purchase is done in a manner that makes the trust a grantor trust. The key issue to be decided by the IRS in the revenue ruling is as follows:

To the extent that a grantor is treated as the owner of a trust, whether the trust will be recognized as a separate taxpayer capable of entering into a sales transaction with the grantor.

The IRS determined that for income tax purposes the trust was not capable of entering into a sales transaction with the grantor as a separate taxpayer. The Revenue Ruling then cited some old cases for the common sense proposition that a taxpayer cannot enter into transactions with himself for income tax purposes and have it recognized. The trust would not be capable of entering into a sales transaction for income tax purposes as a separate taxpayer until the moment of the grantor's death. For income tax purposes, the trust itself is not created and recognized as a separate taxpayer until the moment of the death of the grantor.

If a grantor sells low basis assets to a grantor trust for a note, and if there is an outstanding note **receivable** at death that exceeds the basis of the assets that were sold, is there a capital gains transaction at death when the grantor trust converts into a trust that is for the first time recognized for income tax purposes? The grantor's death is the event, for income tax purposes, that first causes the asset contribution to the trust to be recognized and first causes the sale of certain of those assets to the trust for a note to be recognized. Consider the following analogous example: a decedent directs in his will that his executor contributes certain assets to a trust and sell certain assets to that trust. There would not be any income taxes to the decedent's estate with that sale. Is that the proper analysis when there is an outstanding receivable from a grantor trust at the

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<sup>46</sup> For more on gross estate toggling planning, see Bramwell and Mullen, "Toggling Gross Estate Inclusion On and Off: A Powerful Strategy," *Estate Planning*, Vol. 44, No. 3 (2017).

grantor's death? There is no definitive authority on that question and there is a debate among the commentators as to the correct assumption.<sup>47</sup>

To the extent this is a concern, the note could be paid in-kind by the trust before the death of the grantor (perhaps with a low basis asset that will receive a basis step-up on the death of the grantor). Also, if this is a concern, it could be mitigated by the trustee of the grantor trust borrowing cash from a third party lender and using that cash to eliminate the note owed by the trust to the grantor. The grantor could then use that cash to buy the lowest basis assets owned by the trust. The trustee of the trust could then use the cash it received from the grantor for its purchase of the lowest basis assets to retire its third party lender debt.

- (10) There may be income realization considerations with respect to a note payable that may exist with the grantor trust at the death of the door.

If a grantor purchases a low basis asset from a grantor trust, what is the trust's basis in any note **payable** to the trust by the decedent grantor at the moment of death? The grantor's death is the event, for income tax purposes, that first causes the asset contribution to the trust to be recognized and first causes the purchase of certain of those assets to the trust for a note to be recognized. Consider the following analogous example: a decedent directs in his will that the executor creates a trust with part of the assets of his estate. The decedent then directs that the executor purchases certain of those assets from the trust with a note. The decedent finally directs the executor to pay the note with other assets of his estate. There would not be any income taxes recognized by the trust with that payment. Is that the proper analysis in determining the tax consequences of a payment of a note payable to a grantor trust upon the grantor's death, which is the moment when all of the transactions are first recognized for income tax purposes? Again, there is no definitive authority on what the trust's basis in a note payable to the trust is at the moment of death, and the possibility exists that a court could find that the basis of the note is equal to the basis of the trust assets sold to the grantor at the time of the purchase. The consequences of repaying a note issued to a grantor trust after grantor trust status turns off are discussed in detail below in this paper.

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<sup>47</sup> Compare Cantrell, *Gains is Realized at Death*, TR. & ESTS. 20 (Feb. 2010) and Dunn & Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, 95 J. TAX'N (July 2001) with Gans & Blattmachr, *No Gain at Death*, TR. & ESTS. 34 (Feb. 2010); Manning & Hirsch, *Deferred Payment Sales to Grantor Trust, GRATs, and Net Gifts; Income and Transfer Tax Elements*, 24 TAX MGMT. EST., GIFTS & TR. J. 3 (1999); Hatcher & Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152, 161-64 (2000); Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149 (Sept. 2002).

It should be noted that in addressing the relevance of Reg. §§ 1.1001-2(c) Ex. 5, *Madorin*, 84 T.C. 667 (1985) and Rev. Rul. 77-402, the author(s) of CCA 200923024 observed:

“We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner **which is generally not treated as an income tax event.**” (emphasis added).

To the extent this is a concern, it could be mitigated by the grantor borrowing cash from a third party lender and using that cash to eliminate the note owed to the trust. At a later time, perhaps after the trust is converted to a complex trust for income tax purposes, the grantor (or his executor) could borrow the cash from the trust and pay the third party lender. If the trust, at that later time, does loan cash to the grantor or the executor of the grantor's estate, the trust's basis in that note should be equal to the cash that is loaned.

- (11) On the death of the grantor there will be no step-up in basis in the assets owned by the grantor trust.
- (12) The IRS may contest the valuation of any assets that are hard to value that are donated to a grantor trust or are sold to such a trust.
  - (a) The problem and a probable solution: defined allocation transfers.

The IRS will almost always scrutinize significant transfers of "hard to value" assets. Reasonable people (and, of course, unreasonable people) can differ on the value of certain assets (e.g., a FLP interest). From the IRS's point of view, scrutiny of those assets may represent a significant revenue opportunity. One approach that may reduce the chance of an audit of a transfer of a hard to value asset, or a gift tax surprise, if an audit does occur, is to utilize a formula defined value allocation transfer.<sup>48</sup> A formula defined value allocation transfer may increase the retained interest of the donor (as in the case of a grantor retained annuity trust); may define the portion of the property interest that is transferred or may provide that a defined portion of the property transferred passes to a "tax sheltered recipient." For example, a transfer may provide that an undivided part of a "hard to value" asset, which exceeds a defined value of the transferred entity interest, will pass either to a grantor retained annuity trust,<sup>49</sup> the transferor's spouse,<sup>50</sup> charity<sup>51</sup> or a trust in which the grantor has retained an interest that makes the gift incomplete.<sup>52</sup>

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<sup>48</sup> See S. Stacy Eastland, "The Art of Donating Your Cake to Your Family and Eating It Too: Current Gift Planning Opportunities Using Strings That Are Not Considered Attached by the Donor" 47<sup>th</sup> Annual Heckerling Institute on Estate Planning ¶ 602.2[c]5 (June, 2013).

<sup>49</sup> E.g., the excess could be transferred to a grantor retained annuity trust under IRC Section 2702 that is nearly "zeroed out" with respect to the grantor and uses the required revaluation clause in the trust agreement with respect to a retained annuity.

<sup>50</sup> E.g., the excess could be transferred to a spouse or a marital deduction trust pursuant to a formula marital deduction clause.

<sup>51</sup> E.g., the excess could be transferred to a charity. See *McCord v. Commissioner*, 120 T.C. 358 (2003); *Estate of Christianson v. Commissioner*, 130 T.C. 1 (2008), aff'd 586 F.3d 1061 (8th Cir. 2009); *Hendrix v. Commissioner*, T.C. Memo 2011-133, 101 T.C.M. (CCH) 1642; *Estate of Petter v. Commissioner*, T.C. Memo 2009-280, 99 T.C.M. (CCH) 534.

<sup>52</sup> David A. Handler & Deborah V. Dunn, "The LPA Lid: A New Way to 'Contain' Gift Revaluations," 27 Estate Planning 206 (June 2000).

A discussion of formula valuation clauses is outside the scope of this paper. Taxpayers who employ them during lifetime should be aware that even if a formula clause is successful in defining the value of a gift, the formula clause leaves open for future IRS challenge the amount of property transferred.<sup>53</sup>

- (b) Contribution of a leveraged LLC interest to a Grantor Trust (“LAIDGT” technique).

In order to protect against a note in the SIDGT technique being declared a disguised retention of an equity interest in a trust under equitable tax principles, and to create basis enhancing opportunities that do not exist with the SIDGT technique, a donor may wish to instead create a leveraged entity in which he retains a convertible note and transfers the non-managing equity interest in that entity to a grantor trust. This technique is the LAIDGT. Consider the following example.

*Example 5: Cam Compatible Creates a Leveraged Single Member LLC with a Convertible Note and Then Contributors His Non-Managing Interests to a Grantor Trust*

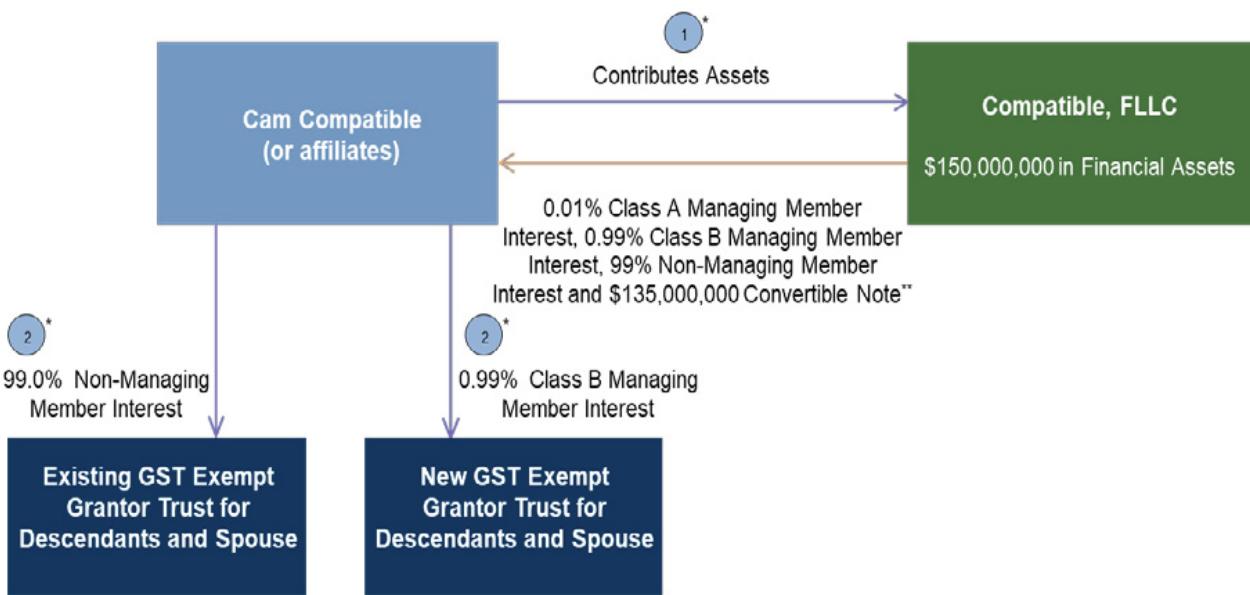
*Cam Compatible owns \$150,000,000 in financial assets. Cam and affiliates (who are not recognized for income tax purposes) contribute \$150,000,000 in assets to a FLLC and receive a 0.1% Class A managing member interest, a 0.99% Class B managing member interest, a 99% non-managing member interest and a \$135,000,000 convertible note (Transaction 1). The note could be converted at any time at the option of the holder to that number of Compatible, FLLC non-managing member interests that are equal in value to the then outstanding principal of the note. The note could have a mandatory conversion feature at the death of the holder of the note. In a separate, independent and distinct transaction (Transaction 2) Cam contributes his 99% non-managing member interest to a grantor trust. The terms of the trust treat his wife, Carolyn, as the discretionary beneficiary and give her certain powers of appointment over the trust.*

*Due to considerations with respect to retaining entity distribution, amendment and liquidation powers, Cam could retain the 0.01% Class A managing member interest and transfer the 0.99% Class B managing member interest. The Class A managing member interests would control all entity managing member decisions, including investment management decisions that are not delegated to the Class B managing member interest. The Class B managing member interests would control all distribution, amendment and liquidation decisions.*

*Cam could give his Class B managing member interest to a grantor trust in which the initial trustee is an advisor or family member he trusts. Cam could have the power to replace the trustee of that donee trust with a new trustee, as long as the replacement trustee is not related or subservient. Assuming a 25.5% valuation discount for the transferred member interests, the technique is illustrated below:*

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<sup>53</sup> For an explanation of why formula clauses fail to achieve finality, see the Bramwell and Dillion, “Not Another Wandry Article: Real Issue with Wandry Formulas,” 41 Estate Planning (May 2014).



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

\*\* The retained note in the LAIDGT technique could be designed to (i) have a mandatory conversion of the amount of non-managing member interests that are equal in value to the principal balance of the note at the death of the holder of the note, and (ii) before death, at the election of the holder, the then outstanding principal of the note could be converted to that amount of non managing member interests that are equal in value to that outstanding principal or a private annuity.

(13) Income tax and basis enhancing advantages of the technique.

(a) The LAIDGT has all of the income tax and basis enhancing advantages of the SIDGT technique and additional advantages that are unique to retaining a convertible note from a single member FLLC.

IRC Sections 671 through 677 contain rules under which the grantor of a trust will be treated as the owner of all or any portion of that trust, referred to as a “grantor trust.” If a grantor retains certain powers over a trust, it will cause the trust to be treated as a grantor trust. If the grantor is treated as the owner of any portion of a trust, IRC Section 671 provides that those items of income, deductions, and credits against the tax of the trust that are attributable to that portion of the trust are to be included in computing the taxable income and credits of the grantor to the extent that such items will be taken into account in computing the taxable income or credits of an individual. An item of income, deduction or credit included under IRC Section 671 in computing the taxable income and credits of the grantor is treated as if received or paid directly to the grantor.<sup>54</sup> Thus, if the private investor contributes assets to an IDGT, the assets will grow (from the point of view of the trust beneficiaries) income-tax free. Furthermore, the IRS now agrees that there is no additional gift tax liability, if the private investor continues to be subject to income taxes on the trust assets and there is no right of reimbursement from the trust.<sup>55</sup> If a

<sup>54</sup> Treas. Reg. § 1.671-2(c).

<sup>55</sup> See Rev. Rul. 2004-64, 2004-2 C.B. 7.

limited liability company is owned by the grantor and/or grantor trusts all of these concepts also apply. In addition, because of IRS regulations, it is clear that all donor activities with a single member LLC (including sales and purchases) are disregarded for income tax purposes. *See* the discussion *infra* Section IV.A.3.a.(13)(b).

Under Rev. Rul. 85-13,<sup>56</sup> a grantor is treated as the owner of trust assets for federal income tax purposes to the extent the grantor is treated as the owner of any portion of the trust under IRC Section 671-77. In that ruling, it was held that a transfer of trust assets to the grantor in exchange for the grantor's unsecured promissory note is not recognized as a sale for federal income tax purposes.<sup>57</sup>

Similarly, if the grantor is treated as the owner of the trust property and transfers property into the trust in exchange for property previously held by the trust, such transfer will not be recognized as a sale, exchange or disposition for federal income tax purposes.<sup>58</sup> Thus, no gain or loss is realized by the grantor or the trust. The basis of the property transferred into the trust is unaffected by the transfer, and neither the grantor or the trust acquires a cost basis in the assets transferred from or to the trust.

It is possible to design a grantor trust, or a single member FLLC, that is defective for income tax purposes (e.g., a retained power to substitute assets of the trust for assets of equivalent value), but is not defective for transfer tax purposes. In comparison to discounting or freezing a client's net worth, over periods of 20 years or more, the effect of the donor paying the income taxes of a grantor trust is generally the most effective wealth transfer technique.

(b) There is greater authority that a sale to a single member FLLC in the LAIDGT technique will be treated as a non-taxable sale to a disregarded entity for income tax purposes than there is for a sale to a grantor trust in the SIDGT technique.

It is clear that a single member FLLC is disregarded for all income tax purposes, including all single member activities (e.g., sales and purchases with the single member FLLC).<sup>59</sup> In *Rothstein v. Commissioner*,<sup>60</sup> the Second Circuit ruled that a purchase from a grantor trust is not ignored because the phrase under IRC Section 671 "shall be treated as the owner of the trust assets" *only* applies for purposes of including the trust's income and deductions

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<sup>56</sup> Rev. Rul. 85-13, 1985-1 C.B. 184.

<sup>57</sup> *See also*, P.L.R. 9146025 (Aug. 14, 1991) (finding that transfer of stock to grantor by trustees of grantor trust in satisfaction of payments due grantor under the terms of the trust does not constitute a sale or exchange of the stock).

<sup>58</sup> *See* P.L.R. 9010065 (Dec. 13, 1989).

<sup>59</sup> *See* Treas. Reg. § 301.7701-3(a); Treas. Reg. § 301.7701-3(b)(1)(ii) and Treas. Reg. § 301.7701-2(a).

<sup>60</sup> *Rothstein v. Commissioner*, 735 F.2d 704 (2nd Cir. 1984).

and does not address donor activities (including sales and purchases) with respect to that trust. *See also* the commentaries of Mark Asher.<sup>61</sup> and Jeff Pennell.<sup>62</sup> As noted above in Rev. Rul. 85-13, however, the IRS announced that it would not follow *Rothstein*.<sup>63</sup>

- (c) The potential basis enhancing advantages of the donor swapping his high basis assets for the income tax disregarded entity's low basis assets.
  - (i) The low basis assets, if retained by the grantor, will receive a basis step-up on the grantor's death.
  - (ii) If the low basis assets are sold by the grantor before his or her death the cost of the capital gains taxes will be borne by the grantor (just as they would have been if the assets had been sold by the grantor trust or a disregarded single member FLLC).
  - (iii) The principal and interest of the donor's retained note may be paid with either cash or in kind. There will not be any income tax consequences with in kind payments, if the grantor trust or single member FLLC remains a disregarded entity.

If low basis assets owned by the disregarded entity are used to make some of those in kind payments, and if those low basis assets are retained by the grantor until the grantor's death, there will be a step-up in basis of those assets on the grantor's death under IRC Section 1014.

(d) Considerations of the swap technique.

The grantor may not have any high basis assets, or cash, to swap. If that is the case, consider a recourse third party loan of cash to the grantor from a third party lender. (While it may be tempting for the donor to simply purchase low basis assets from the disregarded entity, it is not clear what the disregarded entity's basis in the note is – the note's basis may be only

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<sup>61</sup> Mark L. Asher, When to Ignore Grantor Trusts: The Precedents, a Proposal, and a Prediction, 41 Tax. L. Rev. 253 (1986).

<sup>62</sup> Jeffrey N. Pennell, "(Mis) Conceptions About Grantor Trusts," 50<sup>th</sup> Annual Southern Federal Tax Institute.

<sup>63</sup> To the extent that the IRS can distinguish Rev. Rul. 85-13, *Rothstein* makes it possible for the IRS to argue that a trust treated as owned by another person is not disregarded for all tax purposes. This concern arises, for example, in the case of a BDOT, as discussed later in this paper. The use of a single-member FLLC may help alleviate this concern.

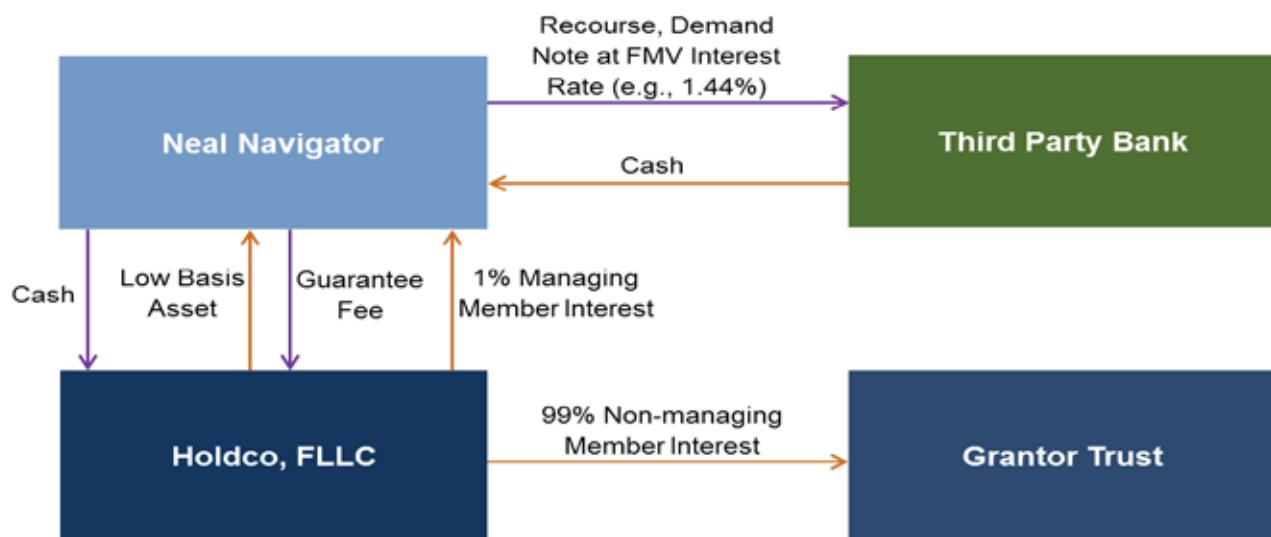
equal to the basis of the purchased assets and capital gains consequences could accrue to the trust when the note is paid.) The grantor could then use that cash to swap for the low basis asset. The grantor trust may then be converted to a complex non-grantor trust. At a later time, in an independent transaction, the grantor could borrow the high basis cash from the trust with a long-term, recourse note that is unsecured and use that cash to pay the principal of the third party loan.

Consider the following illustrated example:

Hypothetical Transaction 1:

*Neal Navigator borrows cash from Third Party Bank and uses that cash to purchase low basis assets from Holdco FLLC, which is 99% owned by a grantor trust. Neal will be personally liable on the bank loan. Holdco FLLC could guarantee the bank's loan to Neal.*

Hypothetical Transaction 1 is illustrated below:



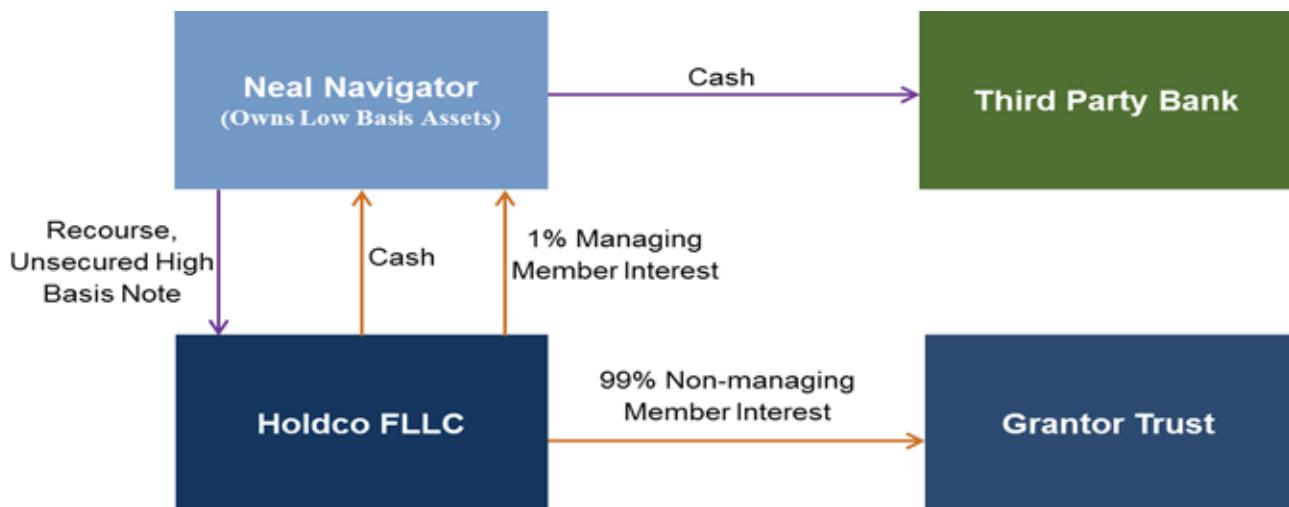
Hypothetical Transaction 2:

*Neal Navigator could continue to borrow from Third Party Bank. Or, in a few years, because he would like the flexibility of a recourse, unsecured long-term note, or because interest rates have moved, or because of some other financial reason, he could borrow cash from Holdco FLLC to extinguish the Third Party Bank note.*

*The recourse, unsecured long-term note with Holdco FLLC will be at a fair market interest rate that is much higher than the AFR. Neal will be personally liable on the note owed to Holdco FLLC.*

*Holdco FLLC's basis in the new recourse, unsecured note may be equal to the cash that is loaned.*

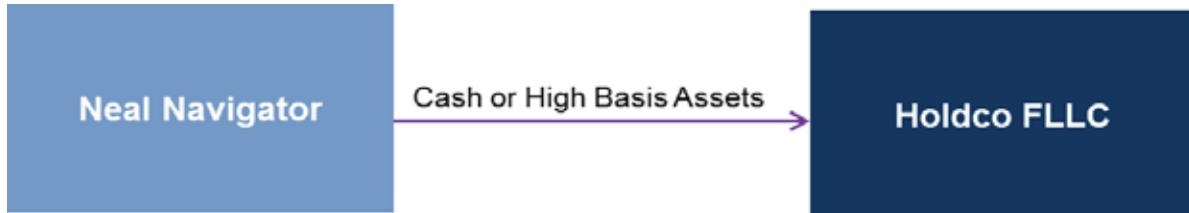
Hypothetical Transaction 2 is illustrated below:



Hypothetical Transaction 3:

*Upon the death of Neal Navigator, the estate satisfies the note to Holdco FLLC with the now high basis assets or cash (if the high basis assets are sold after the death of Neal Navigator).*

Hypothetical Transaction 3 is illustrated below:



(14) The retained note in the LAIDGT technique could be designed to (i) have a mandatory conversion of the amount of non-managing member interests that are equal in value to the principal balance of the note at the death of the holder of the note, and (ii) before death, at the election of the holder, the then outstanding principal of the note could be converted to that amount of non-managing member interests that are equal in value to that outstanding principal.

There are several advantages in making the note convertible as described above.

(a) When the note is converted, that act of conversion does not trigger sale treatment. *See Revenue Ruling 72-265.*

(b) IRC Section 754 elective basis increase in underlying assets.

If there is automatic conversion at the moment of death, an IRC Section 754 Election could be made either at the moment of death or at a later time when certain non-managing interests are purchased in order to finance the payment of estate taxes. In that fashion, certain of the then assets of the FLLC may receive a basis step-up.

It should be noted that this basis enhancing advantage also exists with the classic preferred interest freeze in which the taxpayer retains a preferred interest and transfers the growth interest to his descendants. However, in the preferred interest freeze the coupon is generally much higher than the AFR interest rate in order to have the fair market value of the preferred to equal the par value of the preferred. *See Rev. Rul. 83-120.*

(c) Support for position regarding valuation of note.

The conversion feature will support the argument that the principal of the note is equal to its value.

(d) Additional investment flexibility for holder.

The conversion feature will give the holder of the note additional flexibility to increase his or her future equity exposure.

(e) Ability to turn disregarded entity status on and off.

The disregarded entity status of the FLLC, for income tax purposes, can be easily turned on or off by admitting or redeeming other owners who are not grantor trusts.

(15) There may need to be substantive equity in the trust from prior gifts (is 10% equity enough?) before the sale is made in the SIDGT technique in order for the note not to be treated as a retained interest in the trust under Equitable Tax Principles. That consideration may not exist with the LAIDGT technique.

The note needs to be treated as a note for tax purposes. Generally, estate and gift tax law follows state property law.<sup>64</sup> Thus, there needs to be a strong likelihood that the note will be paid and the capitalization of the trust in the SIDGT technique should not be too “thin.”<sup>65</sup> If the

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<sup>64</sup> See *United States v. Bess*, 357 U.S. 51 (1958); *Morgan v. Commissioner*, 309 U.S. 78 (1940).

<sup>65</sup> In the corporate context see IRC Section 385(b); *Miller v. Commissioner*, T.C. Memo 1996-3, 71 T.C.M. (CCH) 1674; see also IRC Section 385 (titled “Treatment of Certain Interests in Corporations as Stock or Indebtedness”); Notice 94-47, 1994-1 C.B. 357. See also, Staff of the Joint Committee on Taxation, “Federal

assets of the trust in the SIDGT technique are almost equal to the value of the note, the note may not be considered a note under equitable tax principles, but rather a disguised interest in the trust. If the note is considered a disguised interest in the trust, the provisions of the trust and the note may not satisfy the requirements of IRC Section 2702 and, thus, all of the assets of the trust could be considered as having been given to the donees without any offsetting consideration for the value of the note. If the note is considered a disguised retained beneficial interest in the trust, instead of a note, the IRS may take the position that IRC Sections 2036 and/or 2038 apply on the death of the taxpayer.<sup>66</sup> Based on a private letter ruling in 1995<sup>67</sup> and the statutory make-up of IRC Section 2701, many practitioners and commentators seem to be comfortable with leverage that does not exceed 90%.<sup>68</sup> In the LAIDGT, since the note is accruing from the FLLC, and not the trust, the “retaining a trust interest” consideration of the SIDGT technique may be avoided. If there is too much leverage with the LAIDGT technique part of the note will be reconstituted as equity in the FLLC and the disappointment will be that not as much equity will be transferred by gift to the recipient trust. Secondly, because the note is convertible in the LAIDGT technique, there is a stronger argument that at all times the note will be repaid.

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Income Tax Aspects of Corporate Financial Structures,” JCS-1-89, at 35-37 91989), noting that various courts have determined that the following features, among others, are characteristic of debt:

- 1) a written unconditional promise to pay on demand or on a specific date a sum certain in money in return for an adequate consideration in money or money’s worth, and to pay a fixed rate of interest; 2) a preference over, or lack of subordination to, other interests in the corporation; 3) a relatively low corporate debt to equity ratio; 4) the lack of convertibility into the stock of the corporation; 5) independence between the holdings of the stock of the corporation and the holdings of the interest in question; 6) an intent of the parties to create a creditor-debtor relationship; 7) principal and interest payments that are not subject to the risks of the corporation’s business; 8) the existence of security to ensure the payment of interest and principal, including sinking fund arrangements, if appropriate; 9) the existence of rights of enforcement and default remedies; 10) an expectation of repayment; 11) the holder’s lack of voting and management rights (except in the case of default or similar circumstance); 12) the availability of other credit sources at similar terms; 13) the ability to freely transfer the debt obligation; 14) interest payments that are not contingent on or subject to management of board of directors’ discretion; and 15) the labelling and financial statement classification of the instrument as debt. Some of these criteria are the same as those specified in §385, but this elaboration is a more extensive summary of the factors applicable in making the determination.

See also the discussion of what constitutes a valid indebtedness in *Todd v. Comm'r.*, T.C. Memo 2011-123, aff'd per curiam 486 Fed. App. 423 (5th Cir. 2012).

<sup>66</sup> The IRS made that argument in *Karmazin* (T.C. Docket No. 2127-03, 2003), but the case was settled on terms favorable to the taxpayer. In *Dallas v. Commissioner* (T.C. Memo 2006-72) the IRS originally made that argument, but dropped the argument before trial. The IRS also made that argument in two docketed cases, *Estate of Donald Woelbing v. Commissioner* (Docket No. 30261-13) and *Estate of Marion Woelbing v. Commissioner* (Docket No. 30260-13), but the case was settled. Also see *Bixby v. Commissioner*, 58 TC 757 (1972) in which the full Tax Court, in a highly leveraged sale to a trust, recast the seller as a beneficiary of the trust for income tax purposes. While this is an income tax case, there is a similar analysis for IRC Section 677 purposes and IRC Section 2036 purposes.

<sup>67</sup> PLR 9535026 (May 31, 1995).

<sup>68</sup> See Martin Shenkman, “Role of Guarantees and Seed Gifts in Family Installment Sales,” 37 Estate Planning 3 (Nov. 2010).

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- (16) There may be capital gains considerations with respect to the note receivables and/or note payables that may exist with the grantor trust at the death of the donor under the SIDGT technique, but not with the LAIDGT technique with a convertible note that converts at the death of the holder. *See supra* Section IV.A.3.a.(14).
- (17) Transfer tax advantages of the LAIDGT.
  - (a) The LAIDGT technique has all of the transfer tax advantages of the SIDGT technique.
  - (b) The LAIDGT technique can be used to transfer assets from one grantor trust to another when there may be generation-skipping advantages or other advantages in making that transfer.

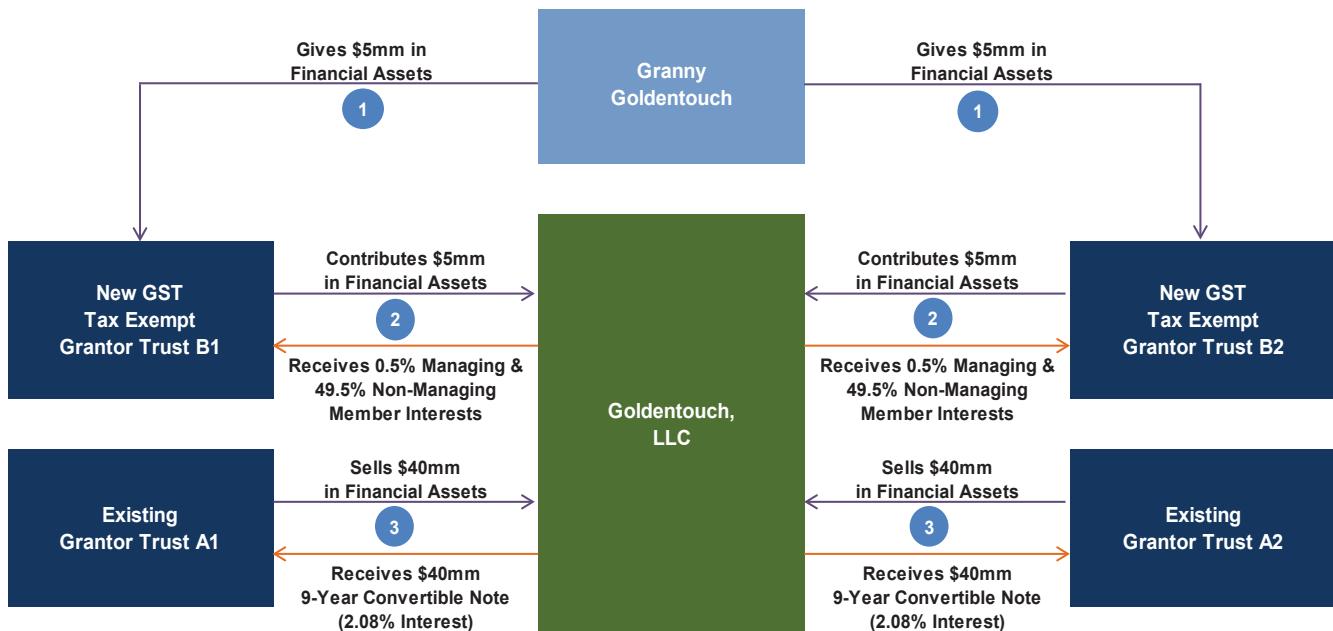
Consider the following example:

*Example 6: A Transferor of a Grantor Trust for His Children (Trust A) Would Like to Indirectly Transfer Some of the Growth of the Assets in Trust A to a Grantor Trust for the Benefit of His Children and Future Descendants (Trust B)*

*Granny Goldentouch (age 60) has created many successful GRATs through the years that have resulted in grantor trusts for each of her two children and each trust has a value of \$40,000,000 (Trust A). Granny has \$10,000,000 in exemption available for gift to dynasty trusts that are grantor trusts. Granny contributes \$5,000,000 each to two dynasty trusts for each of her two grandchildren and their respective descendants (Trust B). Each trust could contribute \$5,000,000 to an LLC. The respective Trust A trusts could sell its assets to the LLC that is owned by the respective dynasty trusts. Granny still has \$75,000,000 in assets after the gifts and plans to spend (inflation adjusted) \$1,250,000.*

*Granny asks her attorney, Pam Planner, what would be the result in 25 years of this plan. Granny asks Pam to assume the assets will earn 7.4% annual return pre-tax (2% of the return will be taxed at ordinary rates and 5.4% of the return will be taxed at capital gains rates with a 30% turnover rate).*

The example is illustrated below:



In 25 years, under the above assumptions, assuming the AFR on the notes and refinanced notes equals 2%, \$353,203,114 in assets will be owned by the grantor dynasty trusts. *See the table below and attached Schedule 5.*

**Table 5**

| Goldentouch Beneficiaries                  |                            | Consumption   |                             | IRS Income Tax |                             | Tax Liability of Estate              |                           | Total        |
|--|----------------------------|---------------|-----------------------------|----------------|-----------------------------|--------------------------------------|---------------------------|--------------|
| Children                                   | Children and Grandchildren | Direct Cost   | Investment Opportunity Cost | Direct Cost    | Investment Opportunity Cost | Embedded Capital Gains Tax Liability | IRS Estate Tax (at 40.0%) |              |
| <b>25-Year Future Values</b>               |                            |               |                             |                |                             |                                      |                           |              |
| No Further Planning                        | \$504,996,444              | \$9,020,000   | \$42,697,205                | \$62,000,386   | \$148,996,173               | \$177,366,284                        | \$11,465,273              | \$26,543,030 |
|  | \$514,016,444              |               |                             | \$104,697,591  |                             | \$326,362,456                        |                           | \$38,008,303 |
| Hypothetical Technique                     | \$178,344,003              | \$353,703,114 | \$42,697,205                | \$62,000,386   | \$149,610,384               | \$177,366,284                        | \$12,898,432              | \$6,464,986  |
|  | \$532,047,117              |               |                             | \$104,697,591  |                             | \$326,976,667                        |                           | \$19,363,419 |
| <b>Present Values (discounted at 2.5%)</b> |                            |               |                             |                |                             |                                      |                           |              |
| No Further Planning                        | \$272,390,329              | \$4,865,303   | \$23,030,471                | \$33,442,425   | \$80,367,133                | \$95,669,704                         | \$6,184,260               | \$14,317,060 |
|  | \$277,255,633              |               |                             | \$56,472,895   |                             | \$176,036,838                        |                           | \$20,501,321 |
| Hypothetical Technique                     | \$96,197,077               | \$190,784,131 | \$23,030,471                | \$33,442,425   | \$80,698,433                | \$95,669,704                         | \$6,957,293               | \$3,487,153  |
|  | \$286,981,208              |               |                             | \$56,472,895   |                             | \$176,368,137                        |                           | \$10,444,446 |

## B. Borrowing from a Grantor Trust.

As discussed below, a grantor may wish to borrow funds from a grantor trust. The reasons for doing so and the associated risks are discussed below, together with possible solutions.

1. Reasons to borrow from a grantor trust.

There are several reasons that a grantor may wish to borrow from a grantor trust. These strategies have gift, estate, and/or income tax risks.

a. Source of liquidity.

A grantor may borrow from a grantor trust for the straightforward reason that the grantor seeks additional liquidity. It may be easier, less time-consuming, or less costly for the grantor to borrow from a trust created by the grantor than from a third party, such as a bank.

b. Financing payment of income taxes.

As discussed above, grantor trust status permits the grantor to pay income taxes on grantor trust income, so that the trust can earn tax-free returns, even as the grantor's own wealth is depleted by the payment of income taxes. The grantor may wish to borrow from the trust in order to finance the grantor's payment of income taxes on the trust's income.

State law or the governing instrument frequently authorizes the trustee of a grantor trust to reimburse the grantor for the income taxes on trust income.<sup>69</sup> The IRS has ruled that the mere existence of such a power, if discretionary with a trustee who is not related or subordinate to the grantor, will not cause the trust to be included in the grantor's gross estate under IRC Section 2036(a)(1).<sup>70</sup> The existence of the power, combined with other circumstances, may, however, cause the trust to become subject to estate tax at the grantor's death. Cautious practitioners, therefore, often advise against reimbursing the grantor. Some even draft trust instruments that forbid reimbursement altogether. Borrowing from the grantor trust may be an alternative to reimbursement when reimbursement may be prohibited or risky. In addition, if the grantor's debt obligation is either repaid during lifetime or deducted for estate tax purposes under IRC Section 2053(a)(3), borrowing is more efficient than reimbursing, as it avoids leakage of trust assets from the trust to the grantor.

c. Borrowing without income tax on interest.

A possible advantage of the grantor borrowing from a grantor trust is that the loan to the grantor will be ignored for income tax purposes under Rev. Rul. 85-13. Thus, the trust will not be subject to tax on interest income (and the grantor will not have an interest deduction). If instead the grantor borrows from an individual member of the grantor's family, the lender would

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<sup>69</sup> See, e.g., New York's Estates, Powers and Trusts Law ("NY EPTL") 7-1.11 (authorizing reimbursement to the creator of the trust out of principal an amount equal to the any income taxes on any portion of the trust principal with which the creator is charged).

<sup>70</sup> Rev. Rul. 2004-64. A problem exists if the discretionary power to reimburse would give the grantor's creditors rights in the trust property under state law. Many states have enacted statutes preventing this. See, e.g., New York's Estates, Powers and Trusts Law ("NY EPTL") 7-3.1(d).

have interest income on the loan. If the interest is classified as personal interest under IRC Section 163(h), the borrower would not have a corresponding interest deduction.

d. Turning on grantor trust status.

Borrowing from a non-grantor trust may turn on grantor trust status. Under IRC Section 675(3), the grantor of a trust is treated as the owner of any portion of a trust with respect to which the grantor has borrowed the corpus or income in any year in which the loan is outstanding for any portion of the year. An exception applies if the loan was made by a trustee, other than the grantor or a related or subordinate party, and the loan provided for adequate interest and security.<sup>71</sup> Even if the grantor repays the loan entirely before the end of the year, the grantor is still treated as the owner for the entire year.<sup>72</sup> IRC Section 675(3) may also cause grantor trust status for the entire year, even though the loan was not in existence at the beginning of the year.<sup>73</sup>

(1) Portion owned.

If the grantor wishes to turn on grantor trust status through an actual borrowing, an important question is what portion is treated as owned by the grantor as a result of the borrowing. The IRS has taken the position in litigation that any borrowing causes the entire trust to be treated as owned by the grantor.<sup>74</sup> The Tax Court, however, has instead applied a formula approach, at least in one set of circumstances.<sup>75</sup>

(2) Using IRC Section 675(3) to acquire appreciated assets from a non-grantor trust to use to make charitable gifts.

The grantor of a non-grantor trust may want to use an appreciated asset held by the trust to make a gift to charity. If the grantor purchases the asset for cash, the trust would recognize gain. If the grantor purchases the asset for an unsecured note, there will be no gain recognition because the purchase turns the trust into a grantor trust, at least to the extent of the purchased property and the note used to purchase it.<sup>76</sup>

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<sup>71</sup> IRC § 675(3); Treas. Reg. § 1.675-1(b)(3).

<sup>72</sup> Rev. Rul. 86-82.

<sup>73</sup> *Mau v. U.S.*, 355 F. Supp. 909 (D. Hawaii 1973).

<sup>74</sup> *Benson v. Comm'r*, 76 T.C. 1040, 1045 (1981) (“It is best to wait for a case clearly presenting the problem to analyze fully respondent's ‘entire trust’ contention.”); *Bennett v. Comm'r*, 79 TC 470 (1982) (“We reject respondent's contention that the grantor is taxable on all the trust income whenever he borrows any of such income”).

<sup>75</sup> *Bennett v. Comm'r*, 79 TC 470 (1982). In *Bennett*, the portion owned by the grantor was equal to a fraction equal to the loan balances on the last day of the taxable year, divided by the total trust income for the years when the loans were outstanding.

<sup>76</sup> IRC § 675(3); *Rothstein v. Comm'r*, 735 F.2d 704 (2nd Cir. 1984); Rev. Rul. 85-13. The *Rothstein* case treated the sale for a note as both a borrowing under IRC Sec. 675(3) and a sale in which the grantor received a cost basis in the purchased assets and the trust realized gain that was in turn reportable by the grantor under IRC Sec. 671. The trust's gain, however, was reported on the installment basis under IRC Sec. 453, so the transaction was

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- e. “Reverse” installment sale to lock in estate tax exclusion before it expires.

The gift and estate tax exclusion amount is currently \$11,580,000, indexed for inflation, but reverts to \$5 million, plus inflation adjustments, after 2025.<sup>77</sup> Under regulations promulgated by the IRS and the Treasury Department, a taxable gift before 2026 must use up the entire enhanced exclusion amount to have the effect of preserving the benefit of the enhanced exclusion after 2025.<sup>78</sup> Taxpayers unwilling to part with assets in order to use up the enhanced exclusion could instead make an initial gift, but then purchase the assets back from the trust in exchange for a note. In this manner, the grantor could use up the enhanced exclusion yet effectively retain ownership of all of his or her assets. If the trust is a grantor trust, no gain or loss would be recognized on the purchase, and any interest on the note would not be subject to tax. Care should be taken to make sure the IRS has no basis for taking the position that the note is not a real note. For instance, a taxpayer with \$15,000,000 in assets could create a single member LLC with a \$11,580,000 preferred interest in a 6% coupon with most of the rest of her assets contributed for a growth interest. The taxpayer could gift the preferred interest to a grantor trust after obtaining a qualified appraisal confirming its fair market value. Assuming the preferred interest is properly structured, IRC Section 2701 will not apply because the taxpayer does not transfer any interest in the LLC that is “subordinate” to the interests retained by the taxpayer. At a later date, the taxpayer could purchase most of the preferred interest from the trust in exchange for a note that pays interest at the AFR. The transfer and repurchase of the preferred interest should be separate and independent transactions.

- f. Guarantee favorable, stable returns to grantor trust.

A grantor may wish to borrow money from an irrevocable grantor trust in order to provide the trust with a favorable rate of return on investments, so that assets can grow during the grantor’s lifetime free of further gift or estate tax. For example, the grantor could borrow low-income producing assets, such as cash, in exchange for an unsecured note paying interest comparable to rates for junk bonds or other high-yield investments if that interest rate is equal to a fair market value rate. The hoped-for outcome is that the grantor’s payment of the interest and principal will cause the trust to earn a higher rate of return than it otherwise could, but without the grantor being deemed to make a taxable gift. See the discussion *infra* at IV(B)(2)(a).

## 2. Gift tax risks of borrowing from a grantor trust.

Both the grantor and the beneficiaries have potential gift tax risks if the grantor borrows from an irrevocable trust.

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not an immediate “wash”. Rev. Rul. 85-13 has effectively superseded *Rothstein* on the question of gain realization, but the case still supports the proposition that a sale for a note is a borrowing that “turns on” grantor trust status.

<sup>77</sup> IRC § 2010(c)(3)(C).

<sup>78</sup> Treas. Reg. § 20.2010-1(c). See T.D. 9984 (Nov. 26, 2019).

a.      Gift tax risks to borrower.

If the grantor borrows from an irrevocable trust, the borrowing will not be treated as a gift by the grantor for gift tax purposes, provided that the value of the grantor's obligation to repay is no greater than the borrowed cash.<sup>79</sup> Normally, the grantor will not be treated as making a gift so long as the face amount of the obligation is equal to the borrowed cash. The value of a note, however, is determined in part by comparing the interest rate on the note to the prevailing interest rates on the market.<sup>80</sup> In theory, therefore, an excessively generous interest rate payable to the grantor trust could cause the grantor to be treated as having made a taxable gift at the time of the borrowing.

For gift tax purposes, a gift occurs, if at all, when a binding promise is made rather than when the obligation is satisfied.<sup>81</sup> Thus, the grantor's repayment of a loan from a grantor trust is not treated as a gift for gift tax purposes.

b.      Gift tax risks to beneficiaries.

A trustee who makes a loan on favorable terms to the grantor – such as if the loan is unsecured or bears interest at low rate – may breach the trustee's duties to the beneficiaries, such as the duties of loyalty and prudence. The beneficiaries, in turn, may have a claim of breach of fiduciary duty against the trustee. Remedies may include voiding the transaction. Beneficiaries who fail to assert a claim for breach of fiduciary duty, and instead consent to or acquiesce in the loan, could conceivably be making an indirect gift to the grantor by permitting the value of their beneficial interests to be impaired by the loan.<sup>82</sup>

3.      Estate tax risks of borrowing from a grantor trust.

Borrowing from a grantor trust can present estate tax risks.

a.      Gross estate inclusion risk.

IRC Section 2036(a)(1) generally provides that property transferred during lifetime is included in the decedent's estate if the decedent retained for life, or for any period which does

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<sup>79</sup> IRC § 2512(b); Treas. Reg. § 25.2511-1(g); Treas. Reg. § 25.2512-8.

<sup>80</sup> Rev. Rul. 81-286; *Blackburn v. Comm'r*, 20 T.C. 204 (1953). If instead the grantor makes a loan to the trust, then Section 7872 overrides this principle and provides a hurdle rate of interest in determining the value of the note for gift tax purposes. *Frazee v. Comm'r*, 98 T.C. 554, 590 (1992); *Estate of True v. Comm'r*, TC Memo 2001-167; PLR 9535026; PLR 9408018; *see also* Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 529 ("[T]he amount of the gift [in the case of a gift loan] is to be determined under section 7872 . . . even if the applicable Federal rate is less than a fair market rate").

<sup>81</sup> *Comm'r v. Copley's Estate*, 194 F.2d 364, 365 (7th Cir. 1952); *Harris v. Comm'r*, 178 F.2d 861, 864 (2d Cir. 1949), *rev'd on other grounds*, 340 U.S. 106 (1950); Rev. Rul. 79-384; Rev. Rul. 84-25.

<sup>82</sup> Rev. Rul. 84-105 (holding that a beneficiary makes an indirect gift by acquiescing in a diversion of trust property); *see also* Rev. Rul. 81-264; Rev. Rul. 86-39.

not in fact end before death (or any period not ascertainable without reference to death), the use, possession, right to income, or other enjoyment of the transferred property. For example, an estate inclusion risk may be present if payments under a promissory note given to the grantor in exchange for property are related to or determined by reference to the income produced by the property.<sup>83</sup>

A retained interest need not be legally enforceable, though, in order for it to cause property transferred during lifetime to be included in the decedent's estate for estate tax purposes. On the contrary, property may be included in the gross estate based on an understanding, express or implied, regarding the decedent's use, possession, or right to income or other enjoyment.<sup>84</sup> In the context of a grantor borrowing from an irrevocable trust, the IRS could contend that, if the grantor-decedent borrowed on favorable terms, such as at a below-market interest rate, the borrowing is evidence of an implied understanding that the grantor would be given the enjoyment or right to income of the trust property.<sup>85</sup>

Many trusts, even those intended to be grantor trusts, have provisions requiring that any loan to the grantor or spouse be for adequate interest and security to comply with IRC Sec. 675(2) and (3), where the intent is to use specific provisions (power of substitution, power to purchase insurance, etc.) to turn grantor trust status on or off without a lending power inadvertently turning it on. Such a provision, if respected by the trustee, should defeat the contention that the grantor retained an interest in the trust through the ability to borrow.

(1)     IRC Section 7872 rate may not be an IRC Section 2036 safe harbor.

IRC Section 7872, where it applies, tests the interest rate charged on an individual's loan in order to determine whether it is a below-market loan. If the loan is below-market gift loan, the lender is deemed to make one or more gifts in the form of foregone interest. A gift loan is a below-market loan where the foregoing of interest is in the nature of a gift. There is no foregone interest, however, so long as the rate is at least equal to the applicable federal rate, as determined under IRC Section 7872. In this way, IRC Section 7872 acts as a safe harbor for gift tax purposes.<sup>86</sup> IRC Section 7872 does not, however, apply to determine whether a decedent retained a right to the income or enjoyment of property transferred during lifetime within the meaning of IRC Section 2036(a)(1). The use of the IRC Section 7872 rate, therefore, does not protect against an inference that the grantor, by receiving loans on favorable terms, retained the right to income or enjoyment of trust property within the meaning of IRC Section 2036(a)(1).

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<sup>83</sup> See *Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S., 274 (1958).

<sup>84</sup> Treas. Reg. § 20.2036-1(c)(1)(i); Rev. Rul. 2004-64; *Linderme v. Comm'r*, 52 T.C. 305 (1969); *Gwynn v. U.S.*, 437 F.2d 1148 (4th Cir. 1971); *Maxwell v. Comm'r*, 3 F.3d 591 (2d Cir. 1993); *Reichardt v. Comm'r*, 114 T.C. 144 (2000); *Kerdolff v. Comm'r*, 57 T.C. 643 (1972); *Paxton v. Comm'r*, 86 T.C. 785 (1986).

<sup>85</sup> Cf. *Rosen v. Comm'r*, T.C. Memo. 2006-115 (applying Section 2036(a)(1) to assets of a family limited partnership, in part on the grounds that the decedent received unsecured purported advances).

<sup>86</sup> *Frazee v. Comm'r*, 98 T.C. 554, 590 (1992); *Estate of True v. Comm'r*, TC Memo 2001-167; PLR 9535026; PLR 9408018.

On the contrary, as the IRC Section 7872 rate is typically less than the interest rate that an arms-length lender would charge, the use of the IRC Section 7872 rate may backfire and increase the risk of estate tax on trust assets (although no case or ruling has yet held so). A possible fix is to consider the LAIDGT technique. *See* the discussion *supra* Section IV.A.3.a.(14).

(2) Additional IRC Section 2035(a) three-year tail risk.

IRC Section 2035(a) provides that if a decedent relinquished a power during the three-year period before death, and retention of the power would have caused gross estate inclusion under IRC Section 2036(a)(1), then the value of the gross estate shall include the property with respect to which the power was released.<sup>87</sup> Under this Section, if a loan to the grantor is treated as evidence of an understanding that the decedent would retain the right to income or enjoyment of trust property under IRC Section 2036(a)(1), then repaying or otherwise cleaning up the loan may not prevent gross estate inclusion unless the grantor survives an additional three years.

b. Non-deductibility of estate tax risk.

A grantor who borrows cash or other assets from an irrevocable trust, and dies obligated to repay the trust, does not augment his or her estate for estate tax purposes so long as the cash or other assets borrowed and included in the grantor's gross estate is offset by a corresponding deduction for the debt obligation. A deduction is generally allowable under IRC Section 2053(a)(3) for claims against the decedent's estate. However, as discussed below, the IRS could argue on various grounds that a deduction should not be allowed.

(1) General requirements of deduction under IRC Section 2053(a)(3).

In general, a claim is deductible under IRC Section 2053(a)(3) if it represents a personal obligation of the decedent, it existed at the time of the decedent's death, and it is enforceable against the decedent's estate and not unenforceable when paid.<sup>88</sup> In addition, unless an exception applies, the claim must either be actually paid by the estate or must meet certain requirements to ensure that the amount of the debt is ascertainable.<sup>89</sup> To ensure deductibility, it is usually wise to have the debt repaid as soon as possible after the decedent's death.

(2) Full and adequate consideration requirement.

A deduction for a claim founded on a promise or agreement – such as the grantor's agreement to repay a loan – is only allowed to the extent that the promise or agreement was bona fide and in exchange for full and adequate consideration in money or money's worth.<sup>90</sup> If the

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<sup>87</sup> Section 2038(a)(1) has its own three-year relinquishment rule. However, as Section 2038 does not apply based on a mere understanding, it seems that this three-year rule is unlikely to apply.

<sup>88</sup> Treas. Reg. § 20.2053-4(a)(1).

<sup>89</sup> Treas. Reg. § 20.2053-4(a)(1); Treas. Reg. § 20.2053-1(d)(4).

<sup>90</sup> IRC § 2053(c)(1)(A); Treas. Reg. § 20.2053-4(d)(6).

grantor borrowed on terms excessively favorable to the grantor trust (such as if the interest rate is above-market), then the IRS could deny a IRC Section 2053(a)(3) deduction on the theory that the grantor's repayment obligation was not contracted for full and adequate consideration, but instead was a device for transferring wealth under cover of a deduction for claims against the estate.

(3) General factors of bona fide loan.

In general, including for purposes of IRC Section 2053(a)(3), courts apply a number of factors in order to determine whether a purported debt is bona fide.<sup>91</sup> These factors include: (1) The name given to an instrument underlying the transfer of funds; (2) the presence or absence of a fixed maturity date and a schedule of payments; (3) the presence or absence of a fixed interest rate and actual interest payments; (4) the source of repayment; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between creditors and equity holders; (7) the security for repayment; (8) the transferee's ability to obtain financing from outside lending institutions; (9) the extent to which repayment was subordinated to the claims of outside creditors; (10) the extent to which transferred funds were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayment. Any failure by the trust to deal with the grantor as a third-party lender creates a risk that the IRS would attempt to deny an estate tax deduction for the debt on the theory that the debt was not bona fide.

(4) Additional factors if claim involves family members or beneficiaries.

Treas. Reg. § 20.2053-1(b)(2) provides that, except in the case of certain charitable claims, “[n]o deduction is permissible to the extent it is founded on a transfer that is essentially donative in character (a mere cloak for a gift or bequest).” If a claim involves family members, a related entity, or beneficiaries, additional factors are considered to determine whether a claim is bona fide.<sup>92</sup>

(5) Inherent risk given factors of bona fide loan.

Given that whether a loan from a grantor trust is bona fide will depend on the facts and circumstances, it is, at a minimum, important to be cautious in the implementation and administration of the loan. Any defect in the course of dealing could be used as leverage by the IRS against an estate seeking to deduct the debt at death.

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<sup>91</sup> See, e.g., *Rosen v. Comm'r*, T.C. Memo. 2006-115; *Miller v. Comm'r*, T.C. Memo. 1996-3, aff'd. 113 F.3d 1241 (9th Cir. 1997); *Todd v. Comm'r*, TC Memo. 2011-123, aff'd per curiam, 486 Fed Appx 423 (5th Cir. 2012).

<sup>92</sup> Treas. Reg. § 20.2053-1(b)(2)(ii).

C. Using a Form of a Grantor Trust Known as a Grantor Retained Annuity Trust (“GRAT”).

1. What is a GRAT?

One form of grantor trust is known as a GRAT.<sup>93</sup> A GRAT is an irrevocable trust to which the grantor transfers an asset in exchange for the right to receive a guaranteed annuity for a fixed number of fiscal years (the “Annuity Period”).<sup>94</sup> When the trust term expires, any GRAT balance remaining is transferred tax free to a designated remainder beneficiary (e.g., a “defective grantor trust” for the benefit of the grantor’s spouse and issue).<sup>95</sup> If a grantor makes a gift of property in trust to a member of the grantor’s family while retaining an interest in such property, the taxable gift generally equals the fair market value of the gifted property without reduction for the fair market value of the retained interest.<sup>96</sup> However, IRC Section 2702 provides that for a gift of the remainder of a GRAT in which the grantor retains a “qualified interest,” defined to include a guaranteed annuity, the taxable gift will be reduced by the present value of the qualified interest, as determined pursuant to a statutory rate determined under IRC Section 7520(a)(2) (the “Statutory Rate”). In general, Statutory Rate requires an actuarial valuation under prescribed tables using an interest rate equal to 120 percent of the federal midterm rate in effect for the month of the valuation.<sup>97</sup>

A grantor’s ability to determine the size of the guaranteed annuity and the annuity period at the outset allows the GRAT to be constructed so that the present value of the grantor’s retained interest approximately equals the value of the property placed in the GRAT, resulting in a “zeroed out” GRAT.<sup>98</sup> If the grantor survives the GRAT term and the GRAT earns a yield or

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<sup>93</sup> If the regulatory requirements set forth in Treas. Reg. § 25.2702-3 are met, the value of the taxpayer’s retained right to payments is subtracted from the value of the property he or she transferred to the trust.

<sup>94</sup> The GRAT may also be structured to terminate on the earlier of a period of years or the grantor’s death, with a reversion of the entire corpus to the grantor’s estate on premature death, but doing so will reduce the value of the retained interest.

<sup>95</sup> IRC Section 2702 provides the statutory authority for such transfers after October 8, 1990. IRC Section 2702(a) uses the “subtraction- out” method to value retained interests of split-interest transfers. Under IRC Section 2702(b), a qualified interest includes any interest that consists of a right to receive fixed amounts. The value of a remainder interest in a GRAT that meets the requirements of IRC Section 2702 is computed by subtracting the present value of the grantor’s annual annuity payments from the contributed properties’ current fair market value. The grantor must recognize a taxable gift to the extent of any computed remainder interest. The present value of the grantor’s annual annuity payment is computed by discount rates set by the IRS under IRC Section 7520. The IRS Tables change monthly to reflect an interest rate assumption of 120% of the mid-term adjusted Federal Rate for that month under IRC Section 1274(d)(1).

<sup>96</sup> See IRC Section 2702(a)(2)(A). Absent IRC Section 2702, the amount of the gift would be reduced by the value of the retained interest.

<sup>97</sup> See, IRC Section 7520(a)(2). Certain exceptions set forth in Treas. Reg. §25.7520-3(b) do not appear to be applicable to the facts discussed in this paper. See Treas. Reg. §25.2511-1(e).

<sup>98</sup>The possibility of completely “zeroing out” a GRAT was negated by Example 9 of Treas. Reg. §25.2702-3(e). Example 9 was invalidated by *Walton v. Commissioner*, 115 T.C. 589 (2000), acq., Notice 2003-72, 2003-44

otherwise appreciates at a rate that exceeds the Statutory Rate, the amount of such excess value should pass to the GRAT's designated beneficiaries free of transfer tax.

2. Advantages of a traditional GRAT.

a. Valuation advantage of a GRAT.

Under the regulations, the grantor's retained annuity rights may be defined in the trust instrument as a percentage of the fair market value of the property contributed by the grantor to the trust, *as such value is finally determined for federal tax purposes*. For example, the trust agreement might provide for payments of 53% per year for two years, where the 53% annual payment amount is derived from the initial value. This type of language operates as a built-in

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I.R.B. 964. Final regulations reflecting Walton and containing a revised Example 9 were issued. *See* T.D. 9181, 2005-1 C.B. 717 (Feb. 25, 2005). Prior to its acquiescence, the IRS, in Rev. Proc. 2002-3, 2002-1 C.B. 117, §4.01(51), announced that it will not issue a favorable private letter ruling in circumstances where the amount of the guaranteed annuity payable annually is more than 50 percent of the initial net fair market value of the property transferred to the GRAT or if the present value of the remainder interest is less than 10 percent of the transferred property's initial net fair market value. This item remains on the "no ruling" list. Rev. Proc. 2015-3, 2015-1 I.R.B. 129, §4.01(53). The regulations do not include any such 50/10 limitation, nor would such a limitation be consistent with the Walton case itself, which involved a zeroed-out GRAT.

The Obama Administration (and perhaps another future democratic administration) proposed changes with respect to GRATs which would require that the remainder have a minimum value. The ability to "zero out" (or almost zero out) the GRAT under current law would be eliminated. See Treasury Department, "General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals" 197-198 (Feb. 2015):

Reasons for Change

GRATs and sales to grantor trusts are used for transferring wealth while minimizing the gift and income tax cost of transfers. In both cases, the greater the post-transaction appreciation, the greater the transfer tax benefit achieved. The gift tax cost of a GRAT often is essentially eliminated by minimizing the term of the GRAT (thus reducing the risk of the grantor's death during the term), and by retaining an annuity interest significant enough to reduce the gift tax value of the remainder interest to close to zero. In addition, with both GRATs and sales to grantor trusts, future capital gains taxes can be avoided by the grantor's purchase at fair market value of the appreciated asset from the trust and the subsequent inclusion of that asset in the grantor's gross estate at death. Under current law, the basis in that asset is then adjusted (in this case, "stepped up") to its fair market value at the time of the grantor's death, often at an estate tax cost that has been significantly reduced or entirely eliminated by the grantor's lifetime exclusion from estate tax.

Proposal

The proposal would require that a GRAT have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years to impose some downside risk in the use of a GRAT. The proposal also would include a requirement that the remainder interest in the GRAT at the time the interest is created must have a minimum value equal to the greater of 25 percent of the value of the assets contributed to the GRAT or \$500,000 (but not more than the value of the assets contributed). In addition, the proposal would prohibit any decrease in the annuity during the GRAT term, and would prohibit the grantor from engaging in a tax-free exchange of any asset held in the trust.

This proposal would apply to trusts created after the date of enactment.

revaluation clause, mitigating the risk of a surprise gift on revaluation of the transferred property by the Service. This feature can be especially beneficial with contributed assets of which reasonable people (and unreasonable people) could differ as to the initial value (e.g., a private derivative, closely held limited partnership interest, or closely held subchapter S corporation stock).

*This valuation advantage may be the most important advantage of the GRAT in comparison to other estate planning techniques. The IRS is not going to argue their own regulations are against public policy like they have with other defined value assignments. The IRS served notice that they are taking dead aim with perhaps a regulations project against other forms of defined value assignments.<sup>99</sup> The disadvantages of a GRAT in comparison to other techniques can all be eliminated or significantly mitigated is the primary thesis of this Section of the paper.*

- b. Ability of grantor to pay for income taxes associated with GRAT gift tax-free and substitute assets of the GRAT income tax-free because it is a grantor trust.
- c. Synergy with other techniques.

A GRAT may be a means to transfer enough wealth to a trust for the benefit of the next generation in order to provide leverage for other future estate planning techniques. If the GRAT, or GRATs, that a grantor and a grantor's spouse create are successful (e.g. 10% of the family's wealth is transferred downstream to the grantor's family or to trusts for the grantor's family), further leveraging with respect to other transfer tax planning techniques could occur. For instance, assume that a GRAT or GRATs that are created by a grantor and a grantor's spouse transfer approximately 10% of the family's net worth to a grantor trust for the benefit of their family. The grantor and the grantor's spouse could transfer their remaining assets to a trust in exchange for a note that is equal to the fair market value of what has been transferred. In that fashion, the grantor has achieved a freeze of his or her estate (except for the interest carry on the note) while paying no (or very little) gift tax. That trust could also purchase life insurance to equal approximately 40% of the projected principal amount of the note due on the death of the surviving spouse. In order to receive a step-up in basis of the underlying assets in the grantor trust the taxpayer could enter into one of the techniques described in *supra* Section IV.A.3.

- d. Comparatively low hurdle rate.

From April, 2017 to April, 2020, the Statutory Rate has ranged between 3.6% and 1.2%. In today's relatively low interest rate environment for US Treasury obligations, it is certainly possible, and for certain investments probable, that the investments of a GRAT will exceed that hurdle rate.

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<sup>99</sup> See Department of the Treasury July 31, 2015 2015-2016 Priority Guidance Plan (Page 14).

e. High leverage.

A GRAT can be created where the grantor retains an annuity amount that is almost equal to the value of the assets there were originally placed in the GRAT. Stated differently, significant leverage can be created by creating an annuity that is almost equal to the value of the assets placed into the GRAT. As noted above, if there is appreciation above the Statutory Rate, the appreciation above the Statutory Rate will accrue to the remainderman. In comparison, most practitioners believe that other leveraged gifting techniques, including a sale to a grantor trust, should have more equity associated with the transaction (e.g., for example, some practitioners advocate at least 10% equity with a sale to a grantor trust, which usually results in a taxable gift).

f. Non-recourse risk to remaindermen.

Another financial advantage of the GRAT technique is that if the asset goes down in value, the remaindermen have no personal exposure. Furthermore, there is no added cost of wasting significant gift tax exemptions of the grantor. For instance, assume for the sake of comparison, that at the time of the sale to the grantor trust, the grantor trust had 10% - 15% equity. If the asset goes down in value, that equity of the trust could be eliminated and the exemptions that were originally used to create that equity could also be wasted.

3. Considerations of using a traditional GRAT.

a. Financial reasons why a GRAT may not succeed.

A famous University of Texas football coach, Darrell Royal, once explained why he disdained the forward pass, “Three things can happen when you throw a pass and two of them are bad.” To a certain extent the same thing can be said about investments that are placed in a GRAT. If the investment goes down (the equivalent of a pass interception), or if an investment only increased modestly (the equivalent of a pass incompletion), the GRAT will be unsuccessful in transferring wealth to the remainderman. Thus, because of investment performance, many GRATs may not be successful. *See infra* Sections IV.C.4.d.(5) for structural techniques that allow a GRAT to work in flat or down markets.

(1) Some assets are not volatile.

Generally, assets that have a chance to have a significant result over the Annuity Period have a wide variance of possible investment outcomes. A stable asset portfolio, while in another context generally desirable, is not a desirable portfolio for a GRAT. If the leading objective of the GRAT is to produce a transfer of wealth to the remainderman, variance of return (or risk) is a friend, not an enemy. Thus, the challenge for the practitioner for clients that have a stable portfolio of assets is how to make the GRAT an effective technique.

(2) Some GRAT investments are only profitable if the investment is long.

Another challenge for the practitioner in dealing with many clients’ normal asset portfolio is that the assets are only profitable if the markets in which the assets are invested

increase. Markets do not always increase in value, nor do the assets which find much of their return related to that market always increase in value. Thus, if the markets are flat, or if the markets are decreasing in value, many of the GRATS created during that period will be unsuccessful.

- b. If a GRAT is not administered properly, the retained interest by the grantor may not be deemed to be a qualified interest.
  - (1) The *Atkinson* worry.

The U.S. Court of Appeals for the Eleventh Circuit (*see Atkinson v. Commissioner*, 309 F.3d 1290 (11<sup>th</sup> Cir. 2002), *cert denied*, 540 U.S. 945 (2003)),<sup>100</sup> has held that an *inter vivos* charitable remainder annuity trust's (CRAT's) failure to comply with the required annual payment regulations during the donor's lifetime resulted in complete loss of the charitable deduction. The Court found that the trust in question was not properly operated as a CRAT from its creation. Even though the subject CRAT prohibited the offending acts of administration, the Court held that the CRAT fails.

In a similar fashion, the Internal Revenue Service could take the position that if the regulations under IRC Section 2702 are violated by the trustee of the GRAT's administrative practices, then the interest retained by the grantor will not be a qualified interest. Just as in the *Atkinson* case, it may not matter if appropriate savings language is in the document. As explored below, there are many areas in which the administration of a GRAT may fail, including the following: (i) not timely paying the annuity amount due to the grantor; (ii) inadvertently making more than one contribution to the GRAT; (iii) inadvertently engaging in an activity (i.e., paying the annuity with a hard to value asset) that would constitute an underpayment of the amount owed to the grantor, which would constitute a deemed contribution; and/or (iv) inadvertently engaging in an activity (i.e., paying the annuity with a hard to value asset) that would constitute an acceleration of the amounts owed to the grantor (a commutation).

## (2) The annuity amount must be paid annually.

An annuity amount payable based on the anniversary date of the creation of the trust must be paid no later than 105 days after the anniversary date. An annuity amount payable based on the taxable year of the trust may be paid after the close of the taxable year, provided that the payment is made no later than the date on which the trustee is required to file the federal income tax return of the trust for the taxable year (without regard to extensions).<sup>101</sup> Failure to pay the annuity amount within these time limits may jeopardize the retained interest by the grantor of the trust from being a qualified interest. If a retained interest in the GRAT is not a qualified interest, then it will have a value of zero for purposes of determining the gift tax associated with the grantor's contribution of assets to the trust.

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<sup>100</sup> See also CCA 200628028 (July 14, 2006).

<sup>101</sup> See Treas. Reg. §25.2702-3(b)(4).

(3) Paying the grantor in satisfaction of his retained annuity interest with hard to value assets may disqualify his retained interest from being a qualified interest, if the assets are valued improperly.

In order to have a successful GRAT, it is obviously desirable to have an asset that has significant potential for appreciation. It is desirable from a volatility and potential growth standpoint to contribute, in many instances, a hard to value asset to the GRAT. Many of the asset classes that have that potential for appreciation (e.g., closely held partnership interests, stock in subchapter S corporations, real estate, hedge funds and other private equity investments) are very difficult to value accurately.

The problem with a GRAT that owns hard to value volatile assets is that when it is time to pay the retained annuity amounts to the grantor, it is often difficult to value the asset that is being used to satisfy the annuity obligation. If the distributed asset is finally determined to have had too low a value when it is used to satisfy the annuity amount owed by the GRAT, it could be deemed to be an additional contribution by the annuitant to the GRAT, which is prohibited. *See* Treas. Reg. §25.2702-3(b)(5). On the other hand, if it is finally determined that the hard to value asset that is distributed in satisfaction of the annuity payment to the grantor had too high a value, it could be determined by the IRS that such a payment is a commutation, which is also prohibited. *See* Treas. Reg. §25.2702-3(d)(5). Thus, the trustee of the GRAT, which is frequently also the grantor, must be very careful, like Goldilocks, to make sure that the annuity payments are “just right”. Using hard to value assets, to make the “just right” payments, may be highly problematic.

*See infra* Section IV.C.4.d.(5) for a structural technique that allows hard to value assets to be contributed to a GRAT, yet does not use those assets to pay the GRAT annuity.

(4) The contribution of assets to the traditional GRAT structure must be made at the exact point of the creation of the GRAT.

As noted above, there cannot be any additional contributions to a GRAT. If an assignment to a GRAT is not effective at the same time of assignment of another asset to a GRAT is made, that could be finally determined to violate the prohibition against additional contributions to a GRAT. That additional contribution could cause the retained interest in the GRAT by the grantor to not be considered a qualified interest for purposes of IRC Section 2702.

*See infra* Section IV.C.4.a. for structural techniques that should solve this consideration.

c. The retained annuity interest is valued using the valuation principles under IRC Section 7520, which is typically higher than interest on an intra-family note.

One of the disadvantages of a GRAT in comparison to sales to intentionally defective grantor trusts is that the qualified interest is valued under IRC Section 7520, which is inherently

higher than the AFR that may be used for notes received for sales to intentionally defective grantor trusts.

*See infra* Section IV.C.4.d.(5) for a structural technique that ameliorates this consideration.

- d. A successful GRAT could regress to the mean by the end of the term of the GRAT.

As noted above, one of the disadvantages of the GRAT is that it cannot be commuted. The GRAT must last its designated term and the only permissible beneficiary of the GRAT during the term of the GRAT is the holder of the annuity interest. Assume a grantor creates a three year GRAT with a volatile stock in which there has been a significant increase in value by the end of year two. If the stock then regresses to a lower price before the end of the third year of the GRAT, less value will pass to the remainderman beneficiaries of the GRAT, than would have been the case, if the GRAT could have been commuted in two years.

*See infra* Section IV.C.4.d.(5) for a structural technique that ameliorates this consideration.

- e. The GST tax exemption may be difficult to leverage through the use of a traditional GRAT structure.

It is difficult to leverage the GST exemption with a GRAT. It is generally thought that the generation-skipping tax exemption of the grantor may not be leveraged, like the gift tax exemption may be leveraged, through the use of a GRAT. This is because of the estate tax inclusion period (“ETIP”) rule found in IRC Section 2642(f)(3), which provides as follows:

Any period after the transfer described in paragraph (1) during which the value of the property involved in such transfer would be includable in the gross estate of the transferor under Chapter 11 if he died. The transferor’s exemption for generation-skipping tax purposes cannot be allocated until after the ETIP period.

Since a grantor is the only beneficiary of a GRAT during the Annuity Period, if the grantor dies during that term a significant portion (usually all) of the assets of the GRAT will be included in the grantor’s estate under IRC Section 2036. Only after the Annuity Period passes and it is clear that the property will not be included in the grantor’s estate for estate tax purposes, may a grantor’s GST exemption be allocated.

- f. A traditional GRAT structure will not be successful in transferring assets if the grantor does not survive until the end of the term of the GRAT.

If a grantor does not survive the Annuity Period a significant portion or all of the assets of the GRAT will be included in the grantor’s estate. The amount of corpus of the GRAT that will be included in the grantor’s estate is that amount that is necessary to yield the annuity payment to the grantor without reducing or invading the principle of the GRAT. The annual

annuity receivable divided by the Section 7520 interest rate equals the amount includable under IRC Section 2036. *See* Treas. Reg. §20.2036-1(c)(2) and Treas. Reg. §20.2036-1(c)(2)(iii), Example 2.

*See infra* Section IV.C.4.d. for structural techniques that may eliminate or substantially ameliorate this consideration.

4. Possible structural solutions to address certain administrative and certain stewardship disadvantages of a traditional GRAT.

- a. Structural solutions to prevent the inadvertent additional contribution of assets to a GRAT.
  - (1) When creating the GRAT, the grantor may wish to consider a provision that prohibits any additional contributions to the GRAT and if any additional contribution is made, a new GRAT must be created specifically to hold that contribution.
  - (2) The grantor of the GRAT may wish to consider initially making the trust revocable. Once all assignments to the trust have been completed, the grantor could amend the trust to make it an irrevocable GRAT.
- b. Structural solutions to ensure that the annuity amount is always deemed to be paid on a timely basis.

The grantor of the GRAT may wish to consider a provision in the trust document that provides (pursuant to a formula) a portion of the trust that is equal to the Annuity Amount due to the grantor shall not be subject to the trust. If that portion remains in the hands of the trustee after the annuity payment date, the trustee shall hold such property only as a nominee, or as an agent, for the grantor. The grantor may also wish to consider a provision in the trust document that the portion of the trust estate that is being held in that agent capacity can be comingled with the trust assets and that the person also serving as trustee has full authority, as agent, to invest the property.

- c. Structural solutions to limit the amount that is received by the remainderman of the GRAT.

Generally, it is advantageous for the grantor to put as much as he or she can afford into a GRAT because that increases the likelihood of the remainderman beneficiaries receiving assets when the GRAT terminates. For instance, assume a client holds an interest in a closely held company. The client believes that within the next few years there could be a monetary event with respect to his stock in the company either through a public offering or a merger. However, assume the client's stewardship goal is that, by the time of his death, a certain dollar amount will pass to trusts for the benefit of his descendants with the rest of his estate passing to his favorite charitable causes. Under those circumstances, the more stock the client contributes to a GRAT,

the greater the chance is that there will be sufficient assets as the end of the term of the GRAT to at least equal stewardship goal he has for his descendants. The inherent conflict with that strategy is that the more stock of the closely held company that he puts into the GRAT the greater the chance that the remainder amount will exceed the stewardship goal that he has for his descendants.

A structural solution for a donor with those stewardship goals is to put a cap on the amount left in the trust for the benefit of his descendants at the end of the annuity term. To the extent that the value of the assets of the GRAT on its termination exceeds that cap, there could be a provision that requires that excess to revert back to the donor. In that manner, the client could be encouraged to contribute most, if not all, of his stock in the closely held business to the GRAT, which helps ensure that the GRAT will be successful in reaching his stewardship goal for his descendants, without the disadvantage of harming his charitable stewardship goals.

d. Solutions to reduce the mortality risk in GRATs.

(1) The grantor could sell her retained annuity interest.

If the sale is made to a grantor trust or to a spouse, the sale will not have any income tax consequences. Although the transfer of a retained interest that would otherwise cause inclusion under IRC Section 2036 is presumptively subject to the three-year rule of IRC Section 2035(a), a sale for full and adequate consideration is exempt under IRC Section 2035(d). The IRS could characterize consideration equal to the remaining value of the annuity as not full and adequate for purposes of IRC Section 2035 under the doctrine of *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961). The viability of *Allen* may be questioned in light of the cases discussed *infra* Section IV.C.5.e. Even if the sale is not for full and adequate consideration, if the grantor lives at least three years after the sale, IRC Section 2036 inclusion should be avoided.

(2) The grantor could use a life insurance to hedge against an early grantor death.

*See* the discussion *infra* Section IV.C.4.d.(5)(c)(i).

(3) The grantor could purchase the remainder interest in a profitable GRAT from the remainder beneficiaries.

If before the end of the term of the GRAT, the GRAT is very profitable and the grantor wishes to lock in the gain and the mortality risk of the grantor, the grantor could purchase the remainder interest. If the remainder beneficiary is a grantor trust, there will not be any income tax consequences triggered by the purchase. The proceeds of the purchase will be removed from the grantor's estate. The IRS could characterize such a purchase as a commutation, as it did for QTIP trusts in Rev. Rul. 98-8, 1998-1 C.B. 541. However, the policy underlying that ruling (to avoid an "end run" around IRC Section 2519) does not apply to a GRAT. In order to preserve this opportunity, the GRAT trust document must not contain traditional spendthrift clauses and must permit a transfer of interests in the GRAT.

(4) The GRAT could be created by the grantor in consideration of full and adequate consideration.

If the remainder interest of a GRAT is not created by gift, but is created for full consideration, IRC Section 2036 should not apply to the GRAT assets, if the grantor dies before the end of the term of the trust. *See* discussion *infra* Section IV.C.5.e.

(5) Consider contributing an interest in a leveraged FLLC to a GRAT (the “LAGRAT” technique).

(a) What is the LAGRAT technique?

All wealthy taxpayers should consider an estate freeze estate planning technique that does not use any of their unified credit, even those taxpayers who have low basis assets. In all states, the marginal transfer tax rate is higher than the marginal federal and state capital gains rate. Thus, removing future growth of a taxpayer’s assets, while preserving the taxpayer’s unified credit to be used at the taxpayer’s death, always results in lower net transfer and capital gains taxes, even for zero basis assets that are not sold during the taxpayer’s lifetime.

Perhaps the best freeze technique that does not have to use any of a taxpayer’s unified credit is described below. In addition to preserving the unified credit in order to receive the maximum step up without estate taxes, varieties of the technique described below also have the potential of saving capital gains taxes beyond the estate freeze.

A taxpayer could create a single member FLLC by contributing and selling financial and private equity assets to that FLLC. If the taxpayer is the only owner of the FLLC there should not be any income taxes or gift taxes associated with the creation of the FLLC.<sup>102</sup> The taxpayer could then contribute some or all of the FLLC member interests to a GRAT. After the term of the GRAT, the remainder beneficiary could be a grantor trust that names the grantor’s spouse as a beneficiary and gives that spouse a special power of appointment. The technique will sometimes be described below as a “Leveraged Asset GRAT” or as a “LAGRAT.”

Consider the following example:

Example 7: Contribution of a Leveraged FLLC Member Interest to a GRAT

*Neal creates a leveraged Holdco. Lenny recommends that Neal contribute \$18,000,000 of marketable securities to a FLP. Due to considerations with respect to retaining entity distribution, amendment and liquidation powers, Neal could retain the 0.01% Class A general partner interest and transfer the 0.99% Class B general partner interest. The Class A general partner interest would control all entity general partner decisions, including investment*

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<sup>102</sup> For the proposition that there should not be any income taxes because the sale of assets to a single member FLLC is ignored for income tax purposes, *see* Treas. Reg. § 301.7701-3(b)(1)(ii). For the proposition that there should not be any gift taxes for a sale of assets for less than the value of the assets on creation of the leveraged single member FLLC, *see Estate of Albert Strangi v. Commissioner*, 115 T.C. 35 (2000).

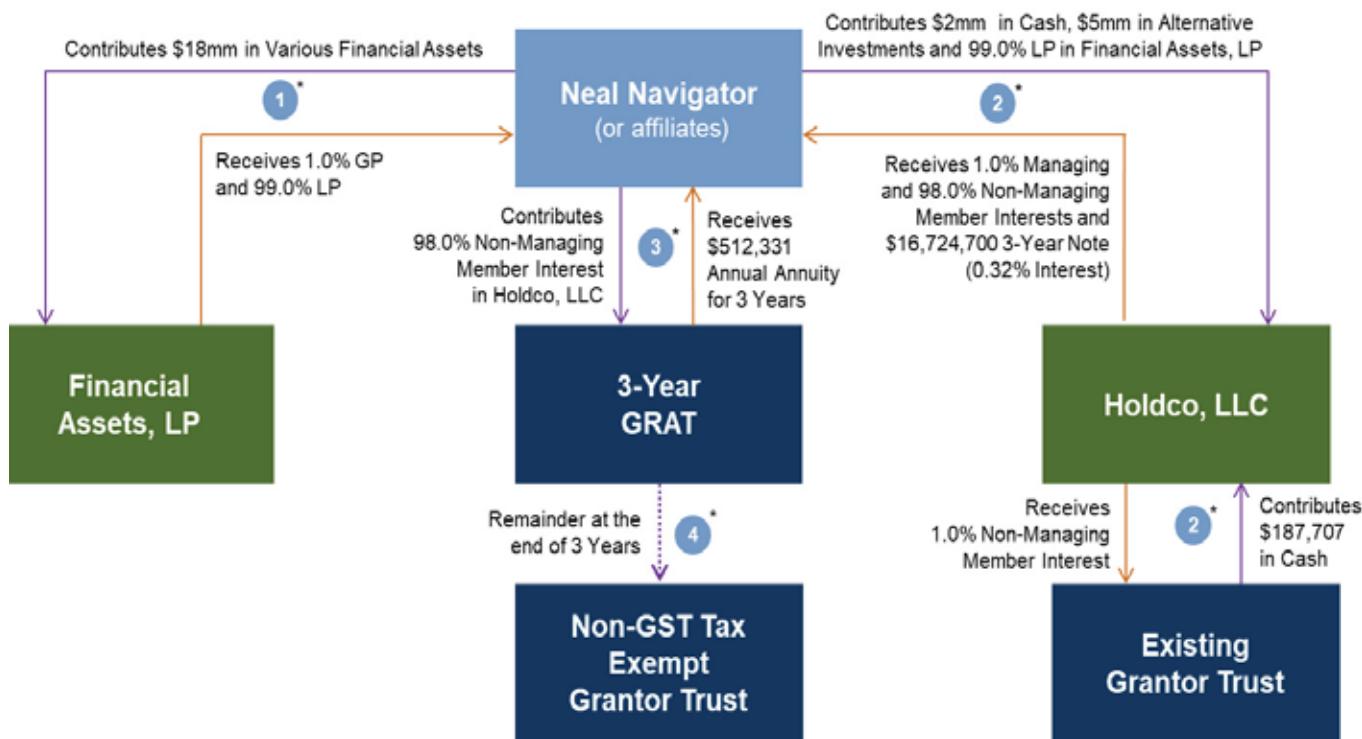
*management decisions that are not delegated to the Class B general partner interest. The Class B general partner interests would control all distribution, amendment and liquidation decisions.*

*Neal could give his Class B general partner interest to a grantor trust in which the initial trustee is an advisor or family member he trusts. Neal could have the power to replace the trustee of that donee trust with a new trustee, as long as the replacement trustee is not related or subservient.*

*Lenny assumes Neal's limited partnership interest in FLP will have a 35% valuation discount. Neal would then transfer the 99% limited partnership interest in FLP, together with \$5,000,000 of alternative investments and \$2,000,000 cash, to a single member FLLC (or "Holdco") in a part sale/part contribution, receiving a convertible note equal to \$16,724,700 (which is 90% of the assumed value of the assets transferred to Holdco). The note could be converted at any time, at the option of the holder to that number of Holdco, FLLC non-managing units that are equal in value to the then outstanding principal of the note. The note could have a mandatory conversion feature at the death of the holder of the note. Due to considerations with respect to retaining entity distribution, amendment and liquidation powers, Neal could retain the 0.01% Class A managing member interest and transfer the 0.99% Class B managing member interest. The Class A managing member interests would control all entity managing member decisions, including investment management decisions that are not delegated to the Class B managing member interest. The Class B managing member interests would control all distribution, amendment and liquidation decisions. Neal could give his Class B managing member interest to a grantor trust in which the initial trustee is an advisor or family member he trusts. Neal could have the power to replace the trustee of that donee trust with a new trustee, as long as the replacement trustee is not related or subservient.*

*Lenny assumes that Neal's non-managing member interest in Holdco will have a 20% valuation discount.*

*Lenny's proposed technique, assuming the IRC Section 7520 rate is 2.2%, is illustrated below:*



The technique described above is designed to join a discounted sale to a grantor trust to a near “zeroed out” GRAT so as to get the best of both worlds.

Instead of this transaction, Neal could create Holdco, FLLC without leverage and transfer his non-managing member interest in Holdco to a grantor trust for his spouse and descendants, taking back a note at the appropriate AFR with a principal amount equal to the discounted value of the transferred interest. In addition, cash or other assets with a value equal to 10% of the total transfer could be gifted to the trust. (Alternatively, the Holdco interest could be sold to the trust for 90% of its discounted value, with no additional gift.) The note could be structured so as not to require interest and principal payments in the near term of more than the trust’s cash flow. The sale will not result in realization of gain because transactions between a grantor and a grantor trust are disregarded. *See discussion supra* Section IV.A.3. The underlying assets have a value in excess of the note equal to the “discount amount” resulting from the discounts for FLP and Holdco, which will be indirectly transferred to the Navigator family.

One aspect of the sale is the requirement that the purchasing trust have sufficient capital in excess of the amount of the note to justify treating the note as debt with a value equal to its face amount. A 10% cushion is widely believed to be the minimum adequate amount. In the technique, the discount amount would actually exceed the required cushion, but it is not clear that reliance on the underlying value that is not reflected in gift tax value would be regarded as sufficient, nor would this be good “optics.” A bargain sale for 90% of value, or a separate gift, would create a 10% cushion, but each result in a taxable gift.

A key disadvantage of this approach is that the assets that are sold or given could be revalued. The IRS might argue for a lower discount in valuing the sold or given assets. A simple price adjustment clause that would increase the sale price to cover the increased value will not

be recognized for gift tax purposes. A defined value transfer that shifts value in excess of the sale price to a marital or charitable disposition might succeed in avoiding a taxable gift but at the cost of diverting property away from the grantor trust, and while this has appellate case law support, there remains legal uncertainty about the success of the technique (the IRS has not acquiesced to the technique). A defined value transfer that reduces the quantum of property transferred to match the sale price has received some case law support, but cannot yet be called a proven technique (the IRS has not acquiesced to the technique), and it too would reduce the property passing to the grantor trust by keeping it with the grantor.

If the note were not treated as debt, because of too much leverage, or for some other reason, then it may be treated as a retained interest in the trust under equitable tax principles, potentially resulting in a taxable gift under IRC Section 2702 and inclusion under IRC Section 2036. *See discussion supra* Section IV.A.3.a.(15). As we shall see, the LAGRAT fineses the debt issue (both as to adequacy of the cushion and as to the result of the note not being treated as debt under equitable principles) by making the sale to a single member FLLC prior to any transfer to the GRAT.

Alternatively, Neal could create Holdco, FLLC without leverage and contribute his non-managing member interest in Holdco to a GRAT. The discounted value of the transfer to the GRAT would be \$14,717,736. For a three-year trust and an IRC Section 7520 rate of 2.2%, the annuity to zero out the transfer would be \$5,123,310. The GRAT in theory solves the problem of getting the discounts generated by FLP and Holdco through the system without making an initial taxable gift. But will this be the case in the real world? The GRAT has no asset other than the Holdco interest. If “slices” of the Holdco interest are used to pay the annuity, the interests distributed must be valued using the valuation discount. Although the distributed slices of the Holdco interest must be valued at a discount, they carry with them the corresponding “full” value of the underlying assets, and nearly the entire Holdco interest must be distributed to satisfy the annuity. The discount amount does not pass to the donees (though some value may remain as a result of earnings on the discount amount). This problem would be solved if the GRAT could distribute cash in satisfaction of the annuity, but Holdco has only \$2 million of cash, plus cash earnings during the GRAT term. Furthermore, the more cash that is distributed from Holdco, the lower the valuation discount will be; which in turn increases the amount of the GRAT annuity that must be paid.

Another approach would be for the GRAT to borrow the amount necessary to pay the annuity in cash from a third party. At the end of the GRAT term, the remainderman would receive the Holdco interest without diminution, and would assume the requirement to eventually repay the note. As long as the remainderman is a grantor trust, the assumption of the note should not be a realization event as to Neal or the GRAT. This approach in effect turns the GRAT into a LAGRAT. Borrowing from a third party results in interest on the loan passing outside the family. The “third party” could, however, be Neal’s spouse or an existing family trust, although taxable interest income to the lender would result.

In summary, unlike the sale to a grantor trust, the contribution of an interest in a non-leveraged entity to a GRAT offers certain protection from an inadvertent taxable gift upon revaluation, but presents the problem of where to get the cash to pay the GRAT’s immediate

annuity obligation, a problem not present with the sale to a grantor trust, where payment of principal and (if need be) interest on the note can be deferred.

The simplest way to “marry” a discounted sale and a GRAT would be to sell assets that could be discounted to the GRAT. Under the facts of this example, the assets transferred to Holdco could instead be sold to the GRAT (itself a grantor trust) for a note with a principal amount equal to 90% of their value, or \$16,724,700. The gross taxable gift is \$1,858,300. The GRAT annuity would be based on this reduced value. Instead of an annuity of \$5,123,310 as in the unleveraged GRAT discussed above, the annuity would be \$646,883. The total annuity payments over three years would have a present value of \$1,858,300. The annuity payments could be satisfied using the \$2,000,000 cash transferred to the GRAT. Even if there were no cash transferred, a 4% annual cash distribution from the assets would be \$743,320, almost enough to cover the annuity and a 0.32% note. The leverage reduces the annuity while protecting from gift tax assets of sufficient magnitude to generate cash sufficient to pay the reduced annuity (or a good portion of it). The annual annuity amount could be further reduced by lengthening the term of the GRAT, until it was covered by the assets’ projected cash flow. Thus, even if the GRAT assets earned only at the 7520 rate, the discount amount would be protected and would pass to the grantor trust that is the GRAT remainderman. Of course, the interest and principal on the note must be paid, but that is a longer-term issue.

One problem with this simple marriage is that the same 10% of the transferred value is both the cushion for the note, and the amount subject to the GRAT annuity. It could be argued that because that 10% will be consumed by the GRAT annuity, there really is no cushion. That may lead to the finding that the note has more characteristics of a retained interest in the trust than a note. If the note is not treated as debt under equitable tax principles, then the note may represent an interest in the trust that is not a qualified annuity under IRC Section 2702, resulting in a taxable gift.<sup>103</sup> It could be argued that the discount amount itself provides a sufficient cushion for the note, but as noted above, it is uncertain whether one can rely for the cushion on value that does not “exist” in determining the value transferred. The only sure solution would be to have a 10% gift taxable component in the transfer that is not offset by the annuity, which Neal wants to avoid. Any such taxable gift would also increase proportionally if the discount were reduced on audit. Another problem with this technique is that if the sale price is inadequate the sale could be deemed to be a deemed contribution. This consideration may be eliminated if the sale is first to a revocable trust. The revocable trust could, at a later time, be amended and become an irrevocable GRAT.

Beyond the cushion issue, the simple marriage of a discounted sale and a GRAT has not been approved in any case or ruling and many practitioners would be reluctant to be the test case of such a novel format.

The LAGRAT technique seeks to avoid the problems of the simple marriage by making the sale of the assets to an intermediate entity, a FLLC with a 1% managing member interest and

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<sup>103</sup> In itself, this might not disqualify the annuity as a “qualified interest,” though the IRS would probably argue that one or another of the requirements of Treas. Reg. § 25.2702-3(d) had been violated.

a 99% non-managing member interest, and then transferring the 99% non-managing member interest in FLLC to the GRAT.

A side benefit of using the intermediate entity FLLC in the above illustration is the additional discount provided by FLLC. The illustration assumes that FLLC would afford an additional discount of 20% on top of the 35% discount afforded by FLP, so that the marketable securities indirectly held in FLLC would have a cumulative discount of 48%. The extra discount affords a benefit but is not the primary reason for using the second entity.

The limited partnership interest in this example, together with the alternative interests and cash, are transferred to FLLC in exchange for a note with a principal amount equal to 90% of the value of the transferred assets. The bargain sale leaves a 10% cushion in support of the note. If the note's validity as debt is tested at the moment of this transfer, it passes the cushion test and presumably is valid debt.<sup>104</sup>

*Even assuming under tax equitable principles part or all of the purported debt from the FLLC is considered equity in the FLLC for tax purposes, the consequences that determination may not be as disastrous as they would be for part or all of a note being considered a retained trust interest in a sale to a grantor trust. That equity interest belongs to Neal, but it is an interest in FLLC, not a direct retained interest in the GRAT. The application of equitable tax principles to treat a retained note as FLLC equity will not be treated as an interest in a trust that is a non-qualified interest under IRC Section 2702.*

(b) Advantages of the LAGRAT technique.

- (i) If leverage is used in creating the FLLC that is contributed to the GRAT, much more wealth will be transferred to the remainderman of the GRAT than contributing assets that are not entities to a GRAT or a FLLC that is contributed to the GRAT without leverage.

In comparing the LAGRAT to a GRAT that uses discounted entities, but does not use leverage, and to a GRAT that does not use either discounted entities or leverage, under the above assumptions, the transfer tax advantage of the LAGRAT is significant. The tables below summarize the advantage. The calculations below are made after two years, ignoring valuation discounts, and are net of the outstanding debt. The assumed IRC Section 7520 rate is 2.2%. The tables below assume different rates of returns, as noted (also see Schedule 6 attached).

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<sup>104</sup> Of course, at the moment of sale nothing turns on whether the note is debt or an interest in FLLC, since Neal already owns all the interest in FLLC. Only on the subsequent transfer to the GRAT does it become important that the note be treated as debt to avoid a possible taxable gift and potential inclusion (but see the discussion below of the consequences of “flunking” the debt test).

**Table 6a**

| Hypothetical Techniques<br>Scenario 1: Assets Earn 2.20% Annually,<br>IRS 7520 Rate of 2.20%      | Neal<br>Navigator | Navigator<br>Children | % Improvement<br>Over<br>Technique #1 | % Improvement<br>Over<br>Technique #2 |
|---|-------------------|-----------------------|---------------------------------------|---------------------------------------|
| No Further Planning   | \$26,553,039      | \$0                   | N/A                                   | N/A                                   |
| Technique A: Contributing Assets That Are Not in Entities to a GRAT                               | \$26,552,894      | \$144                 | N/A                                   | N/A                                   |
| Technique B: Contribution of Non-Leveraged Entities to a GRAT                                     | \$24,217,863      | \$2,335,176           | 1619182.15%                           | N/A                                   |
| Technique C: Leveraged FLLC Asset Contributed to a GRAT   | \$18,781,789      | \$7,771,250           | 5388721.91%                           | 232.79%                               |
| Technique D: Two Leveraged FLLCs (Preferred and Growth) Assets Contributed to Two Different GRATs | \$17,455,005      | \$9,098,034           | 6308754.37%                           | 289.61%                               |

**Table 6b**

| Hypothetical Techniques<br>Scenario 2: Assets Earn 7.40% Annually,<br>IRS 7520 Rate of 2.20%      | Neal<br>Navigator | Navigator<br>Children | % Improvement<br>Over<br>Technique #1 | % Improvement<br>Over<br>Technique #2 |
|---|-------------------|-----------------------|---------------------------------------|---------------------------------------|
| No Further Planning   | \$30,292,932      | \$0                   | N/A                                   | N/A                                   |
| Technique A: Contributing Assets That Are Not in Entities to a GRAT                               | \$27,409,575      | \$2,883,358           | N/A                                   | N/A                                   |
| Technique B: Contribution of Non-Leveraged Entities to a GRAT                                     | \$24,501,833      | \$5,791,099           | 100.85%                               | N/A                                   |
| Technique C: Leveraged FLLC Asset Contributed to a GRAT   | \$18,401,811      | \$11,891,122          | 312.41%                               | 105.33%                               |
| Technique D: Two Leveraged FLLCs (Preferred and Growth) Assets Contributed to Two Different GRATs | \$17,080,466      | \$13,212,466          | 358.23%                               | 128.15%                               |

**Table 6c**

| Hypothetical Techniques<br>Scenario 3: Assets Earn 10.00% Annually,<br>IRS 7520 Rate of 2.20%     | Neal<br>Navigator | Navigator<br>Children | % Improvement<br>Over<br>Technique #1 | % Improvement<br>Over<br>Technique #2 |
|---|-------------------|-----------------------|---------------------------------------|---------------------------------------|
| No Further Planning   | \$32,295,905      | \$0                   | N/A                                   | N/A                                   |
| Technique A: Contributing Assets That Are Not in Entities to a GRAT                               | \$27,826,552      | \$4,469,353           | N/A                                   | N/A                                   |
| Technique B: Contribution of Non-Leveraged Entities to a GRAT                                     | \$24,569,260      | \$7,726,645           | 72.88%                                | N/A                                   |
| Technique C: Leveraged FLLC Asset Contributed to a GRAT   | \$18,186,732      | \$14,109,173          | 215.69%                               | 82.60%                                |
| Technique D: Two Leveraged FLLCs (Preferred and Growth) Assets Contributed to Two Different GRATs | \$16,784,233      | \$15,511,672          | 247.07%                               | 100.76%                               |

Under all rates of return, the LAGRAT substantially outperforms the other techniques. The reason for the improved performance with the contribution of member interests in a leveraged FLLC is (i) the average hurdle rate is lower with leverage and (ii) the GRAT annuity amount is paid with the normal distributable cash flow of the FLLC instead of discounted FLLC member interests. The chief reason for the outperformance is the second reason. A significant arbitrage is created when a heavily discounted asset is contributed to a GRAT and undiscounted cash is used to pay the annuity.

As noted below, not only does paying the GRAT annuity with cash, instead of discounted entity interests, produce a much better transfer tax result, it does not present “deemed contribution” or “deemed commutation” concerns that could accrue if hard to value assets are used to pay the GRAT annuity.

- (ii) The LAGRAT technique has many of the same advantages as the sale to the grantor trust.

IRC Sections 671 through 677 contain rules under which the grantor of a trust will be treated as the owner of all or any portion of that trust, referred to as a “grantor trust.” If a grantor retains certain powers over a trust, it will cause the trust to be treated as a grantor trust. If the grantor is treated as the owner of any portion of a trust, IRC Section 671 provides that those items of income, deductions, and credits against the tax of the trust that are attributable to that portion of the trust are to be included in computing the taxable income and credits of the grantor to the extent that such items will be taken into account in computing the taxable income or credits of an individual. An item of income, deduction or credit included under IRC Section 671 in computing the taxable income and credits of the grantor is treated as if received or paid directly to the grantor.<sup>105</sup> Thus, if the private investor contributes assets to an intentionally defective grantor trust, the assets will grow (from the point of view of the trust beneficiaries) income-tax free. Furthermore, the IRS now agrees that there is no additional gift tax liability, if the private investor continues to be subject to income taxes on the trust assets and there is no right of reimbursement from the trust.<sup>106</sup>

It is possible to design a grantor trust, or a single member FLLC, that is defective for income tax purposes (e.g., a retained power to substitute assets of the trust for assets of equivalent value), but is not defective for transfer tax purposes. In comparison to either discounting or freezing a client’s net worth, over periods of 20 years or more, the effect of paying the income taxes of a grantor trust is generally the most effective wealth transfer technique there is.

Assuming there is appreciation of the FLLC assets above the interest carry on any note, the appreciation will not be subject to estate taxes in either the grantor’s estate or the grantor spouse’s estate. This is a significant transfer tax advantage. According to our calculations, where joint life expectancies exceed 20 years, this is the second biggest driver of transfer tax

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<sup>105</sup> Treas. Reg. §1.671-2(c).

<sup>106</sup> See Rev. Rul. 2004-64, 2004-2 C.B. 7.

savings for a client's family. (The most important driver for saving transfer taxes, over a 20-year period, as mentioned above, is the donor paying the income taxes of the trust on a gift tax-free basis.) The interest on the note does not have to be any higher than the applicable federal rate in order to ensure there are no gift tax consequences. *See* IRC Section 7872. The applicable federal rate, depending upon the length of the term of the note is equal to the average Treasury securities for that term. *See* IRC Sections 7872 and 1274(d).

If the grantor cannot afford to pay the remainder trust's income taxes in the future, the trust could be converted to a complex trust that pays its own income taxes. However, converting the trust to a complex trust could have income tax consequences if the then principal balance of the note is greater than the basis of the assets that were originally sold to the FLLC. That difference will be subject to capital gains taxes.<sup>107</sup>

- (iii) There is inherent flexibility to meet changing consumption needs with the grantor retaining a note from the FLLC that could be converted to a note with a different interest rate or a private annuity.

The note retained by the grantor could also be structured and/or converted to meet the grantor's consumption needs, without additional gift taxes, as long as the restructuring is for adequate and full consideration.

For instance, the note at a future time could be converted to a private annuity to last the grantor's lifetime. That conversion should be on an income tax free basis since, as noted above, the trust and any consideration received for any sale to the trust are ignored for income tax purposes. At the time of the conversion to a private annuity it is important that enough assets exist in the FLLC to satisfy IRC Section 7520 exhaustion test requirements.

The note could also be restructured to pay a different interest rate, as long as the new rate is not lower than the AFR rate or higher than the fair market value rate.

- (iv) There is an inherent flexibility to enter into basis enhancing strategies with the LAGRAT.

The use of this technique freezes the taxpayer's assets on a discounted basis. In other words, the appreciation of the assets, similar to a sale of a discounted asset to a grantor trust, is not subject to the taxpayer's future estate taxes. Unlike a sale to a grantor trust that is created by substantial use of a taxpayer's available unified credit, the technique does not require the use of the taxpayer's unified credit. Any unified credit that can be saved by using this technique may be used by the taxpayer to save estate taxes and capital gains taxes on the low basis assets owned

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<sup>107</sup> *See* Treas. Reg. §1.1001-2(e), Ex. 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 722.

by the taxpayer at his death. Thus, this may be an ideal technique for a taxpayer who wishes to preserve his unified credit to save estate taxes and capital gains taxes on certain low basis assets he may own at the time of his death.

The principal and interest of the retained note may be paid with either cash or in kind. There will not be any income tax consequences with in kind payments, if the FLLC remains a disregarded entity. If low basis assets owned by the FLLC are used to make some of those in kind payments, and if those low basis assets are retained by the grantor until the grantor's death, there will be a step-up in basis of those assets on the grantor's death under IRC Section 1014.

The creator of the FLLC, as long as it is a disregarded entity, could swap his individually owned high basis assets with the FLLC's low basis assets. The creator of the FLLC could also buy the low basis assets from the FLLC for a note. However, if the note is paid back after the creator's death there may be capital gains consequences to the then owners of the FLLC. The FLLC's basis in the note may be equal to the basis of the low basis assets that are purchased.

A better course of action for the creator of the FLLC who does not have any high basis assets, may be to borrow cash from a third party lender to make that exchange. At a later time, the creator could refinance the note to the third party lender by borrowing cash from the FLLC. Generally, Neal's estate taxes will not increase with this basis enhancing technique because the acquisition of low basis assets, which will be taxable in Neal's estate, are offset by the note owed either to third party lender or, at a later time, to the FLLC.

- (v) The “*Atkinson*” worry about paying a GRAT annuity with a hard-to-value asset may be eliminated.

If the annuity amount is kept relatively small because of the use of leverage, then there may be enough cash flow to pay the annuity with cash or near cash. In Example 7 there would be more than enough cash flow to and from the FLLC to pay both the interest on the note and the GRAT annuity. Obviously, there are no valuation issues with cash. The U.S. Court of Appeals for the Eleventh Circuit (*see Atkinson*, 309 F.3d 1290 (11<sup>th</sup> Cir. 2002), cert denied, 540 U.S. 945 (2003)),<sup>108</sup> has held that an inter vivos charitable remainder annuity trust's (CRAT's) failure to comply with the required annual payment regulations during the donor's lifetime resulted in complete loss of the charitable deduction. The Court found that the trust in question was not properly operated as a CRAT from its creation. Even though the subject CRAT prohibited the offending acts of administration, the Court held that the CRAT fails.

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<sup>108</sup> See also C.C.A. 200628028 (July 14, 2006).

In a similar fashion, the IRS could take the position that if the GRAT trustee's administrative practices violate the regulations under IRC Section 2702, then the interest retained by the grantor will not be a qualified interest. Just as in the *Atkinson* case, it may not matter if appropriate savings language is in the document. As explored below, there are many areas in which the administration of a GRAT may fail, including the following: (i) inadvertently engaging in an activity that would constitute an underpayment of the amount owed to the grantor, which would constitute a deemed contribution; and/or (ii) inadvertently engaging in an activity that would constitute an acceleration of the amounts owed to the grantor (a commutation).

In order to have a successful GRAT, it is obviously desirable to have an asset that has significant potential for appreciation. It is desirable from a volatility and potential growth standpoint to contribute, in many instances, a hard to value asset to the GRAT. Many of the asset classes that have that potential for appreciation (e.g., closely held partnership interests, real estate, hedge funds and other private equity investments) are very difficult to value accurately.

The problem with a GRAT that owns hard to value volatile assets is that when it is time to pay the retained annuity amounts to the grantor, it is often difficult to value the asset that is being used to satisfy the annuity obligation. If the distributed asset is finally determined to have had too low a value when it is used to satisfy the annuity amount owed by the GRAT, it could be deemed to be an additional contribution by the annuitant to the GRAT, which is prohibited. *See* Treas. Reg. §25.2702-3(b)(5). On the other hand, if it is finally determined that the hard to value asset that is distributed in satisfaction of the annuity payment to the grantor had too high a value, it could be determined by the IRS that such a payment is a commutation, which is also prohibited. *See* Treas. Reg. §25.2702-3(d)(5). Thus, the trustee of the GRAT, which is frequently also the grantor, must be very careful, like Goldilocks, to make sure that the annuity payments are "just right". Using hard to value assets, to make the "just right" payments, may be highly problematic. Language in the trust requiring that any payment be retroactively adjusted if later found to be incorrect may help, but is not certain to negate an *Atkinson* type challenge.

- (vi) There may be less danger that the retained note will be recharacterized as a deemed retained interest in a trust under equitable tax principles with this technique than with a sale to a grantor trust.

The IRS has purportedly made the argument under certain circumstances (e.g., when there is significant leverage) that, in substance, the sale for a note to the grantor trust is a contribution to the trust with a deemed retained interest.<sup>109</sup> If, under equitable tax principles, the

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<sup>109</sup> The IRS made that argument in *Karmazin v. Commissioner*, No. 002127-03 (T.C. file Feb. 10, 2003), but the case was settled on terms favorable to the taxpayer. In *Dallas v. Commissioner*, 92 T.C.M. (CCH) 313 (2006), the IRS originally made that argument, but dropped the argument before trial. The IRS is currently making both of those arguments in two docketed cases, *Estate of Donald Woelbing v. Commissioner*, No. 30261-13 (T.C. filed Dec. 26, 2013) and *Estate of Marion Woelbing v. Commissioner*, No. 30260-13 (T.C. filed Dec. 26, 2013).

transaction is treated as a deemed contribution to the trust with a deemed retained trust interest, severe gift tax and estate tax consequences could accrue under IRC Sections 2702, 2036 and 2038. Unfortunately, there are no authorities that can provide the taxpayer with guidance on an amount of leverage that may safely be used with a trust.

It should also be noted that the IRS, in its recent Priority Guidance Plan issued on July 31, 2015, appears to be taking dead aim at the sale for a note to a grantor trust that is subject to a defined value assignment.<sup>110</sup>

The GRAT/FLLC technique employs leverage, but the leverage is in the organization of the entity. Numerous debt/equity tax cases exist regarding whether the debt is treated as a disguised equity in that context. There is ample authority and guidelines on that subject, particularly in interpreting IRC Section 385.<sup>111</sup> Furthermore, as noted above, assuming the FLLC is recognized for transfer tax purposes, if the note is found not to be a note under equitable tax principles, the note will be treated as retained equity in the FLLC. The note should not be

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<sup>110</sup> Please see 3, 5, and 8 of that guidance plan, which states as follows:

3. Guidance on basis of grantor trust assets at death under IRC Section 1014.  
...
5. Guidance on the valuation of promissory notes for transfer tax purposes under IRC Sections 2031, 2033, 2512, and 7872.  
...
8. Guidance on the gift tax effect of defined value formula clauses under §§2512 and 2511.

<sup>111</sup> In the corporate context, *see* IRC Section 385(b); *Miller v. Commissioner*, T.C. Memo 1996-3, 71 T.C.M. (CCH) 1674; *see* the discussion of what constitutes a valid indebtedness in *Todd v. Commissioner*, T.C. Memo 2011-123, aff'd per curiam 486 Fed. App. 423 (5th Cir. 2012); *see also* IRC Section 385 (titled "Treatment of Certain Interests in Corporations as Stock or Indebtedness"); Notice 94-47, 1994-1 C.B. 357. *See also*, Staff of the Joint Committee on Taxation, "Federal Income Tax Aspects of Corporate Financial Structures," JCS-1-89, at 35-37 (Jan. 18, 1989), available at <https://www.jct.gov/publications.html?func=showdown&id=2238>, noting that various courts have determined that the following features, among others, are characteristic of debt:

- 1) a written unconditional promise to pay on demand or on a specific date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest; 2) a preference over, or lack of subordination to, other interests in the corporation; 3) a relatively low corporate debt to equity ratio; 4) the lack of convertibility into the stock of the corporation; 5) independence between the holdings of the stock of the corporation and the holdings of the interest in question; 6) an intent of the parties to create a creditor-debtor relationship; 7) principal and interest payments that are not subject to the risks of the corporation's business; 8) the existence of security to ensure the payment of interest and principal, including sinking fund arrangements, if appropriate; 9) the existence of rights of enforcement and default remedies; 10) an expectation of repayment; 11) the holder's lack of voting and management rights (except in the case of default or similar circumstance); 12) the availability of other credit sources at similar terms; 13) the ability to freely transfer the debt obligation; 14) interest payments that are not contingent on or subject to management of board of directors' discretion; and 15) the labelling and financial statement classification of the instrument as debt. Some of these criteria are the same as those specified in §385, but this elaboration is a more extensive summary of the factors applicable in making the determination.

treated as a retained interest in a trust with the attendant IRC Sections 2702 and 2036 considerations.

- (vii) There is greater authority that a sale to a single member FLLC will be treated as a non-taxable sale to a disregarded entity for income tax purposes than there is for a sale to a grantor trust. *See* the discussion *supra* Section IV.A.3.a.(13)(b).
- (viii) The LAGRAT avoids the necessity of continually creating GRATs using the so-called “cascading GRATs” technique.

Using this technique is a one-time solution at the end of the GRAT annuity period, the grantor has a perfect freeze (the grantor only owns a note and a small equity interest). The grantor does not need to keep forming GRATs to freeze his estate, which saves on legal and appraisal costs and is also administratively easier to execute.

## (c) Considerations of the LAGRAT technique.

- (i) If the grantor does not survive the term of the GRAT, part or all of the net value of the leveraged FLLC interests owned by the GRAT and the then value of the outstanding note receivable from the FLLC could be taxable in the grantor's estate.

If the grantor does not survive the term of the GRAT, the IRS takes the position that IRC Section 2036 will include the assets of a GRAT in the grantor's estate equal to the lesser of the value of the assets in the GRAT, or the dollar amount of the retained annual annuity divided by the then IRC Section 7520 rate.<sup>112</sup> Under the facts of Example 7, if the IRC Section 7520 rate increases to 5% before the GRAT terminates, and if the grantor dies before the end of the term of the GRAT, the lesser of the net value of the GRAT or \$10,246,240 ( $\$512,321 \div 5\%$ ) will be included in the estate of the grantor (Neal Navigator). Assuming the assets earn 7.4% annually before taxes the net value of Holdco in three years will be \$12,381,520, assuming valuation discounts will not be allowed. *See infra* Schedule 6. However, that amount is greater than \$10,246,240. Thus, the maximum amount included under IRC Section 2036 under those facts, is \$10,246,240. The then principal amount of the note is also included in the grantor's estate under IRC Section 2033.

There are a number of techniques to eliminate the IRC Section 2036 concern that a death by the grantor of the GRAT will include some or all of the GRAT assets in the grantor's estate. *See supra* Section IV.C.4.d.

One of the techniques is for part of the liquidity that is directly or indirectly owned by the GRAT to be invested in life insurance instead of financial assets to hedge against Neal's early death. As noted above, if the IRC Section 7520 rate rises to 5% at the time of Neal's death, because of the formula under the IRC Section 2036 regulations, the maximum under the facts of Example 7 that will be included in Neal Navigator's estate because of the GRAT annuity is \$10,246.620 ( $\$512,321 \div 5\%$ ). Also, if Neal dies before the GRAT annuity ends, under IRC Section 2033 the value of Neal's note receivable and the 1% retained managing member interest will also be taxable in his estate. The estate taxes associated with the IRC Section 2036 and IRC Section 2033 inclusion with Neal's early death could be mitigated or "hedged," if either the Holdco FLLC or Financial Assets LP purchases life insurance with Neal being the insured. There is a long line of authority that life insurance owned by a partnership entity is only taxable in the insured's estate under IRC Section 2033, and is not included in the insured's estate under IRC Section 2042.<sup>113</sup>

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<sup>112</sup> See Treas. Reg. §§ 20.2036-1(c)(2)(i), 20.2036-1(c)(2)(iii), Ex 2.

<sup>113</sup> See Treas. Reg. § 20.2042-1(c)(2); *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), aff'd on another issue, 244 F.2d (4th Cir. 1957), cert denied, 355 U.S. 827 (1957), acq. in result, 1959-1 C.B. 4; Rev. Rul. 83-147, 1983-2 C.B. 158; *Watson v. Commissioner*, 36 T.C.M. (CCH) 1084 (1977); *Estate of Fuchs v.*

Under Example 7, assume Neal is 60 years old and Financial Assets, LP buys a combination of 10-year term life insurance and permanent life insurance to pay for the potential estate tax cost of Neal's passing within three years of creating the LAGRAT. Assuming the estate tax rate is 40%, Neal would need to purchase a maximum of \$4,098,648 of term life insurance ( $\$10,246,620 \times 40\%$ ) to pay the estate taxes because of the IRC Section 2036 inclusion of the GRAT, and a maximum of \$6,689,880 ( $\$16,724,700 \times 40\%$ ) of permanent life insurance to pay for the IRC Section 2033 inclusion of Neal's note receivable and the remaining 1%-member interest in Holdco FLLC.

The cost of the ten-year term life insurance premiums to hedge or pay for the potential IRC Section 2036 inclusion would be \$10,893 each year. The annual cost of the \$6,689,880 permanent life insurance policy to hedge or pay for the potential IRC Section 2033 inclusion would be \$93,362 a year.<sup>114</sup> Thus for an annual outlay of \$104,255, which is .417% of the assets subject to the LAGRAT in this example, Neal Navigator's early death estate tax problem is solved.

Under those facts, if Neal is then in the maximum estate tax bracket and has used all of his estate tax exemption, and has an early death, the synergy of the use of the LAGRAT and the use of life insurance is quite remarkable. The loss of the family's net worth is reduced from 40% to a little over 1%.

Obviously, after the GRAT annuity period ends the IRC Section 2036 exposure also ends and Neal could terminate the term life insurance and the associated premiums. Neal could also terminate or reduce the permanent life insurance premiums as his IRC Section 2033 estate tax exposure because the retained note is also reduced.

- (ii) The LAGRAT is more complex to initially create than the traditional GRAT (but it is less complicated than using the alternative "freeze" technique of cascading GRATs that would be created each year).

While this technique solves considerations in paying GRAT annuities with hard to value assets and has the distinct advantage of substantially outperforming other GRAT techniques, it is more complex to initially create. However, after the termination of the GRAT, it should not be any more complex to administer than a sale of partnership interests to a grantor trust.

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*Commissioner*, 47 T.C. 199 (1966); *Estate of Infante v. Commissioner*, 29 T.C.M. (CCH) 903 (1970); *Estate of Tompkins v. Commissioner*, 13 T.C. 1054 (1949).

<sup>114</sup> Many thanks to Preston Sartelle of Capital Strategies Group, Inc. who used certain current assumptions of current TIAA-CREF life insurance products to give the author the above annual premium assumptions.

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- (iii) Care must be taken to make sure that there is not a violation of the treasury regulation that prohibits “issuance of a note, or other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount.”

If there is an indirect issuance of a note in satisfaction of the retained GRAT annuity amounts, the annuity amounts will not be considered qualified annuity interests and the annuity amounts will be worth zero in determining the gift to the remainder trusts. *See* Treas. Reg. § 25.2202-3(b)(1). In the context of the examples of this outline, the gift would be the fair market value of the non-managing member interests that were transferred to the GRATs. That gift would be comparatively low, around 8% of the gross value of the assets of the FLLC (assuming a 20% valuation discount and 90% leverage with respect to the FLLC), but the indirect issuance of a note in satisfaction of the annuity amount should be avoided.

Borrowing from others to make annuity payments is not addressed in the regulations, but is expressly acknowledged as being acceptable in the preamble to the regulations, if the step transaction doctrine does not apply. A GRAT borrowing from the grantor for purposes other than making annuity payments, such as to enable the trust to make other investments (or allowing the entity the GRAT owns to make other investments like the Holdco, FLLC in this example), is not addressed and, therefore, should be viewed as permissible, subject to the “directly or indirectly” step transaction caveat. In the LAGRAT technique, it should be easy to trace the borrowing proceeds from a grantor to an investment by the GRAT, or some other use by the GRAT (e.g., paying expenses), other than making an annuity payment.<sup>115</sup>

All of the retained leverage by the grantor in the LAGRAT technique is associated with the creation of Holdco when the grantor contributes assets in exchange for a note from Holdco. The grantor in this technique never loans money to the GRAT for any purpose, including the purpose of providing liquidity so that the GRAT can pay the GRAT annuity with liquid assets.

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<sup>115</sup> See the discussion by Ronald D. Aucutt in “Grantor Retained Annuity Trusts (GRATs) and Installment Sales to Grantor Trusts.” The American Law Institute Continuing Legal Education Planning Techniques for Large Estates (Apr. 8-10, 2015).

(iv) Care must be taken to make sure that the IRS cannot successfully take the position that the creation of Holdco, FLLC should be ignored for gift tax purposes and that the retained notes are in reality retained trust interests in the GRAT that do not constitute a qualified annuity interest under IRC Section 2702.

Holdco, FLLC could be disregarded under two different theories: (i) a single member FLLC should be *per se* disregarded for both income tax purposes and transfer tax purposes and/or (ii) even if single member FLLC's should not be disregarded for transfer tax purposes on a *per se* basis, the step transaction doctrine applies to the facts of the transaction and the FLLC is disregarded for transfer tax purposes.

*The argument that the FLLC should not be ignored for gift tax purposes on a per se basis, or under the step transaction doctrine, is greatly strengthened if the FLLC is also partially owned by another disregarded entity (e.g., an existing grantor trust) before the donor contributes his part of the non-managing member interests in the FLLC to the GRAT(s).*

Even though the single member FLLC is *per se* disregarded for income tax purposes (see Treas. Reg. § 301.7701-3(b)(1)(ii)), it is not disregarded for gift tax purposes. In *Pierre v. Commissioner*, 133 T.C. 24 (2009), the full Tax Court held that because transfer taxes follows state law property rights, interests in a single member FLLC were valued for gift tax purposes as FLLC interests and not, as the IRS argued, with reference to underlying asset values.<sup>116</sup> The IRS has not acquiesced in the decision.

As noted in the examples, care should be taken to make sure that the leveraged creation of FLLC is recognized as an independent transaction under the step transaction doctrine. In applying the step transaction doctrine, the IRS or court may not treat the various steps of the transfer as independent. Instead, the steps may be collapsed into a single transaction.<sup>117</sup> Under the circumstances of the gift of a non-managing member interest in a leveraged FLLC to a GRAT, the crucial key to not run afoul of the step transaction doctrine may be establishing that the creation of the FLLC should stand on its own, especially if there is another owner of the FLLC as in the above example. Could the act of a transferor creating the leveraged FLLC be independently separated from the gift to the GRAT? The creation of the FLLC should be designed to be sufficiently independent on its own and as an act that does not require a gift to

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<sup>116</sup> A subsequent memorandum decision, T.C. Memo 2010-106, applied the step transaction doctrine to collapse certain sale and gift transfers of 9.5% and 40.5% into single 50% transfers.

<sup>117</sup> See Donald P. DiCarlo, Jr., "What Estate Planners Need to Know About the Step Transaction Doctrine," 45 Real Prop. Tr. & Est. L.J. 355 (Summer 2010).

the GRAT. There does not have to be a non-tax purpose for the creation of and gift to the GRAT. It is difficult for this writer to understand the non-tax purpose of any gift.

The Supreme Court has said on two separate occasions that estate and gift tax law should be applied in a manner that follows a state property law analysis.<sup>118</sup> Thus, the key questions could be, is the creation of the FLLC with leverage recognized for state property law purposes, and is its creation independent of any other events, including the subsequent gift to the GRAT? Stated differently, for state law property purposes, would the creation of the FLLC be recognized independent of the gift to the GRAT? It would seem to this writer that in many situations it could be demonstrated that the creation of the FLLC did not require a gift to the GRAT for state law property purposes or for tax purposes. Furthermore, creating a FLLC with debt has economic risk to the current owners and future owners of the FLLC. The creation of the FLLC has both risk and reward. The value of the FLLC assets could depreciate below the value of the note. Depending upon the size of the transaction, 10% equity may represent real risk in comparison to the reward of the leverage. One percent equity may not.

An excellent discussion of the interrelationship of creating a FLLC, transferring a member interest in a FLLC, state property law, federal transfer tax law and the step transaction doctrine is found in the *Linton*<sup>119</sup> case.

If the creation of the FLLC is ignored for gift tax purposes, then under equitable tax principles the sale and contribution of the underlying assets of the FLLC is to the GRAT instead of to the FLLC. The value of the GRAT will increase. Assuming the valuation discount for the transferred non-managing member interests is 20%, then ignoring the valuation discounts will increase the value of the GRAT by 20% and the GRAT annuity amounts will increase by 20%.

If the creation of the FLLC is ignored for gift tax purposes, does it matter what the terms of a trust are in determining if the cushion is adequate on a sale to a trust in order to have a note recognized as a note instead of as a retained interest in the trust? It may matter. On its face, there may be plenty of cushion on the sale and the note would be recognized as a note. However, the terms of this trust, after payment of trust obligations, are that all of the net assets are to be distributed to the grantor of the trust (who is also the owner of the note) unless there is growth of the assets. Does the fact that the GRAT is in effect a short term trust in which most of its assets are to be distributed to the grantor, after payment of the outstanding note to the grantor, equitably convert the note to a retained interest in the trust? If the note is treated as a retained interest in trust, the terms of the note may not comply with the definition of a qualified payment

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<sup>118</sup> See *United States v. Bess*, 357 U.S. 51 (1958); *Morgan v. Commissioner*, 309 U.S. 78 (1940).

<sup>119</sup> See *Linton v. United States*, 630 F.3d 1211 (9th Cir. 2011); see also the following cases which also held that the step transaction doctrine did not apply under the facts of the case: *Holman v. Commissioner*, 601 F.3d 763 (8th Cir. 2010); *Senda v. Commissioner*, 433 F.3d 1044 (8th Cir. 2006); *Gross v. Commissioner*, T.C. Memo 2010-176 (2010). But see *Heckerman v. United States*, 104 A.F.T.R. 2d 5551 (W.D. Wash. 2009), which held the step transaction doctrine did apply.

under IRC Section 2702 and the gift will be all of the assets of the GRAT minus the annuity payments that do qualify.

- (v) Care must be taken if the underlying asset that is sold or contributed to the single member FLLC is stock in a subchapter S corporation.

Assuming the FLLC is a single member FLLC and/or is owned by other disregarded entities for income tax purposes, the FLLC may own subchapter S stock.<sup>120</sup> If the FLLC is not a single member FLLC, it will not be a permissible shareholder of a subchapter S corporation and the subchapter S election will be terminated. The FLLC should be drafted to make it clear that it dissolves and liquidates upon the earlier of a term of years or the death of the single member owner. If the FLLC terminates and dissolves on the single member's death, the subchapter S election may be preserved.<sup>121</sup>

e. Swap out volatile assets of unsuccessful GRATs.

A grantor might wish to borrow from a GRAT in order to swap out volatile assets of unsuccessful GRATs, so that those assets may be transferred to new GRATs while the value of the assets is depressed. As with a swap from a GRAT in order to lock in successful performance, a grantor wishing to swap out volatile assets from an unsuccessful GRAT could substitute in cash or other low-volatility assets.<sup>122</sup> As an alternative, the grantor could also consider issuing a note to the GRAT in exchange for the volatile assets.

5. Possible structural solutions to allow the allocation of the GST exemption upon the creation of a GRAT.

a. Introduction.

The “conventional wisdom” this author sometimes hears on this subject is as follows: “the remainderman of a GRAT cannot be a generation-skipping trust” or “you can use the leverage of a GRAT for gift tax purposes, but you cannot use that leverage for

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<sup>120</sup> See PLRs 9739014, 9745017, 200107025 and 20008015. These private letter rulings do not consider whether an FLLC having a grantor and grantor trust as members will be considered to have only one owner and therefore remain a disregarded entity, but they support that result.

<sup>121</sup> See PLR 200841007. In this private letter ruling the deemed single member LLC was owned by five separate grantor trusts when the grantor died. One day after the grantor's death, the LLC was liquidated and distributed its subchapter S stock to the new five non-grantor trusts. The representative of the grantor represented that the existence of the new partnership for one day after the grantor's death was inadvertent and was not motivated by tax purposes. The IRS agreed that the LLC was deemed to terminate on the day of the grantor's death and the subchapter S election remained in effect.

<sup>122</sup> See generally Dillon & Reed, “Letting GRATs Fail for Success,” *Trusts & Estates*, Vol. 157, No. 12 (December 2018).

generation-skipping tax purposes.” This “conventional wisdom,” under the circumstances described below, may be incorrect.

As noted above, a GRAT can be structured to have almost no gift tax value attributable to the remainderman, valued as of the creation of the trust. If the asset that has been contributed to GRAT outperforms the IRC Section 7520 interest rate, that outperformance results in a gift tax free gift to the remainderman. Thus, the gift tax exemption can be substantially leveraged using the GRAT technique.

It is generally thought that the generation-skipping tax exemption of the grantor may not be leveraged in a similar fashion. This is because of the estate tax inclusion period (“ETIP”) rule found in IRC Section 2642(f)(3), which provides as follows:

Any period after the transfer described in paragraph (1) during which the value of the property involved in such transfer **would be includable in the gross estate of the transferor under Chapter 11 if he died**. The transferor’s exemption for generation-skipping tax purposes cannot be allocated until after the ETIP period. (Emphasis added.)

Stated differently, whether a generation-skipping transfer has occurred cannot be determined until after it is determined whether the property will be included in the grantor’s estate. If the period passes, and it is clear the property will not be included in the grantor’s estate, then and only then, may the grantor’s GST exemption be allocated.

- b. If there is a 5% or less probability that estate tax inclusion will occur because of the death of the grantor, is there an exception to the ETIP rules applying, which allows an upfront allocation of a GST exemption?

(1) The technique.

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

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

For a short term GRAT there will often be less than a 5% probability that the grantor will die during the GRAT term. For example, this will be true for a two-year GRAT unless the grantor is above 70 years of age. In such a case, the exception noted above would literally apply. On this reading of the exception, the ETIP rules will not apply to an allocation of GST exemption, upon creation of the GRAT because there is less than a 5% chance that the grantor will die during

the GRAT term. Thus, a grantor age 70 or younger can create a two-year GRAT in which the remainderman is a generation-skipping trust, make an upfront allocation of the GST exemption.

(2) Advantages of the technique.

Using that GRAT structural technique, when the ETIP rules do not apply, and allocating GST exemption to the GRAT assets on creation of the GRAT, even if there is not an offset for the retained GRAT annuity, is not much of a “penalty” with the LAGRAT technique. The reason why there is not much of a penalty with that structural technique is because the retained GRAT annuity is a relatively modest part of the leverage being employed in the transfer to the GST exempt trust.

For instance, see Example 7 *supra* Section V.C.4.d.(5)(a). Assume the grantor in that example is young enough that there is only a 5% probability that the grantor will die during the GRAT annuity period. Because of the leverage embedded in the contributed FLLC member interest to a GRAT and the assumed valuation discounts, the taxpayer would only have to allocate \$1,471,774 of his GST exemption to make the GRAT and the remainder trust exempt from the generation-skipping transfer tax because those trusts will have a zero inclusion ratio. That is obviously more than the one-dollar gift tax exemption that needs to be allocated. However, it may still be an efficient use of the GST tax exemption as Tables 1a, 1b and 1c illustrate. At the end of three years, because of the arbitrage of discounted assets going into the GRAT and a relatively modest amount of cash being used to pay the GRAT annuities, even if the assets grow at the modest IRC Section 7520 rate of 2.2%, the GST trust would, upon termination of the GRAT in three years, have a value of \$7,771,229 (see Table 6a *supra* Section V.C.4.d.(5)(b)(i)), if the valuation discounts are ignored in valuing the GST assets at that time. That is clearly an efficient use of the upfront allocation of \$1,471,774 in GST exemption.

(3) Considerations of the technique.

If the grantor wishes to have a zero inclusion for GST purposes for the trust, can he use an amount of upfront allocation of the GST exemption that is equal to the amount of the taxable gift of the GRAT remainder, which subtracts the retained GRAT annuity in determining the gift? Or does the grantor, if he wishes to have a zero inclusion for GST purposes for the trust, have to make an upfront allocation of the GST exemption that is equal to the full value of the trust without subtracting the annuity payments? There is not any definitive authority on this subject, but most commentators believe the IRS will resist the result that an upfront allocation of the GST exemption equal to the gift tax amount works to achieve zero inclusion.<sup>123</sup> Ed Manigault and Mil Hatcher discuss this issue and note the following:<sup>124</sup>

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<sup>123</sup> See PLR 200107015: Covey & Hastings, “Recent Developments 2007,” 42nd Annual Heckerling Institute of Estate Planning, University of Miami School of Law (page 295). See Manigault and Hatcher, “GRATs and GST Planning – Potential Pitfalls and Possible Planning Opportunity,” 20 Prob. & Prop. 28 (2006).

<sup>124</sup> See Manigault and Hatcher, “GRATs and GST Planning – Potential Pitfalls and Possible Planning Opportunity,” 20 Prob. & Prop. 28, 32 (2006).

Although it appears that some GRATs should fall outside of the ETIP rule—depending on the age of the grantor and the term of the annuity period—it is not clear *how much* GST exemption would need to be allocated to the GRAT to provide for a zero inclusion ratio. If the allocable amount necessary to produce a zero inclusion ratio was tied to the taxable *gift* amount, then using a nearly zeroed-out GRAT would seem to permit the allocation of an amount only equal to the minimal taxable gift.

The provisions for allocation of GST exemption, however, do not clearly define the allocation amount based on the amount of the taxable gift. Instead, the regulations arguably point to the *amount of the property transferred*, not to the amount of the taxable gift. *See* Treas. Reg. §26.2632-1(b)(1)(i), (2)(i) and (ii), and (4). This approach is consistent with the determination of the applicable fraction (for purposes of calculating the inclusion ratio), which has as its denominator the value of the property transferred to the trust. *See* Treas. Reg. §26.2642-1(c)(1). It might then be the position of the IRS that, if the above interpretation of the ETIP exception is accurate, a grantor must allocate GST exemption equal to the amount transferred to the GRAT, not the minimal taxable gift created as a result of the funding of the GRAT.

The argument that the authors make is that the amount transferred for generation-skipping tax purposes should be offset by the consideration received by the grantor. In the case of the GRAT, the consideration received is the present value of the amount of the annuities that the grantor is to receive. In the case of a transfer to a generation-skipping trust, pursuant to a bargain sale, it is commonly accepted that the amount of the GST exemption that needs to be allocated is the amount of the transfer after subtracting the value of the consideration received. The natural question is why should the result be different if the consideration received is an annuity (from a GRAT) as opposed to a seller-financed note from a non-GRAT trust? To take the analogy a little bit further, assume that a grandparent makes a bargain sale to an “old and cold” adequately funded trust (presumably a defective grantor trust) in which the consideration for the “sale” part of the bargain sale is not a seller financed note, but a private annuity. One would assume that the selling grandparent should be able to insulate the trust from GST taxes by allocating her GST exemption in an amount equal to the “bargain” gift component (this assumes the annuity will be recognized on its own terms and not as a disguised retained income interest that is subject to IRC Section 2036). Thus, the question is why should a transaction involving a bargain sale private annuity be treated differently than a transaction involving an annuity from a GRAT, as far as determining the amount of the property transferred for GST tax exemption allocation purposes?

The taxpayer should assume that the ETIP rules do not apply if there is less than a 5% probability that a GRAT will be included in the gross estate and the GST exemption may be allocated on the creation of the GRAT. **However**, a conservative taxpayer should assume in allocating the GST exemption on the creation of the GRAT, if an inclusion ratio of “0” is desired, that he should allocate a GST exemption amount that is equal to the amount of the property transferred, without netting out the retained GRAT annuity.

Is there a situation, when the 5% exception applies, where the above debate, about whether the retained annuity in a GRAT can be used as an offset in calculating the allocation of the GST exemption, at the time of the creation of the GRAT, is generally irrelevant? There may be. Consider a defined formula remainder GRAT with a small retained annuity in comparison to the value of the asset that is contributed to the GRAT, because the annuity amount is defined as a result of a “defined value” remainder that is a significant, specific dollar amount.<sup>125</sup> Using the “defined value” remainder, allocating a GST exemption to a LAGRAT on its creation could still work very well for generation-skipping transfer tax purposes. The client, under those circumstances, may be content with allocating the GST exemption to all of the assets that are held in the GRAT. If the 5% exception under Treas. Reg. Section 26.2632-1(c)(2) applies, the GST exemption may be allocated to the GRAT when it is created. In such a case, the GRAT operates with two very useful features: (1) the amount of the transfer for gift tax purposes will not increase even if the initial value of the trust increases upon audit, and will remain protected from gift tax if it is less than the unified credit applicable to the transfer. If the IRS takes the view that the assets have a greater value than the filed gift tax return would indicate, the increased annuity will offset the increase in asset values; and (2) if values are not increased upon audit, the GST exemption allocated will make the continuing trusts GST exempt and protect subsequent appreciation from GST tax. If values are increased on audit, the GRAT may be only partially exempt for GST tax purposes. In that event, upon termination of the GRAT, the continuing trust could be bifurcated into a trust that is GST exempt and another trust that is not GST exempt.

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<sup>125</sup> For example, the formula might define the annuity as that percentage of the initial value of the trust assets (as finally determined for federal gift tax purposes) which will result in an annuity having a present value at the inception of the trust equal to the initial value of the trust assets (as so determined) less \$4,800,000. Also assume under this example that the value of the annuity is \$400,000 and the grantor has an available gift tax exemption and GST tax exemption of \$5,400,000. The grantor could allocate \$4,800,000 of his available gift tax exemption and \$5,200,000 of his GST tax exemption to the GRAT. A GRAT annuity defined in this way has not been passed upon by the IRS or the courts. It should meet the requirements of Treas. Reg. 25.2702-3(b)(i)(B), which permits the annuity to be “[a] fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes, payable periodically but not less frequently than annually, but only to the extent the fraction or percentage does not exceed 120 percent of the fixed fraction or percentage payable in the preceding year.” In order to freeze the remainder value at a constant dollar amount, such a formula definition generates a greater annuity percentage (not just a greater annuity amount) for a higher initial value. The percentage is dependent upon finally determined asset values and is fixed by them, since there is only one percentage corresponding to any given initial value of the trust. It therefore is hard to see in what sense this would not be a “fixed percentage,” and the regulatory definition, with its reference to values “as finally determined for federal tax purposes,” seems entirely consistent with defining the annuity percentage in this way. An initial annuity percentage defined in this way could then be made subject to the 20% annual increase permitted under the regulation, although that is not a feature of the technique under discussion.

- c. Is there a technique that uses the leverage of the GRAT to indirectly profit a GST trust in which a skip person is not the remainderman of the GRAT at the beginning or end of the ETIP (and does the technique work)?
  - (1) The technique.

Another interesting inquiry is whether a grandparent who creates a GRAT will be deemed to have made a transfer that is subject to generation-skipping taxes, if the remainderman at the beginning and at the end of the ETIP period of the GRAT is not a skip person? The answer would seem to be no.

However, does that answer change if the original remainderman, who is not a skip person, during the ETIP period transfers, for full and adequate consideration, sells her remainder interest to an existing generation-skipping trust that the remainderman has created and at a later time buys back that remainder interest (presumably before the ETIP period ends)? In other words, has the grandparent who created the GRAT made a generation skipping transfer despite naming a non-skip person as the remainderman who in fact receives the remainder after the ETIP period ends? If the original remainderman and the remainderman at the end of the ETIP period is a non-skip person, but during the ETIP period there are non-taxable transfers by the remainderman to and from a generation-skipping trust, has a generation-skipping transfer been made? Consider the following example:

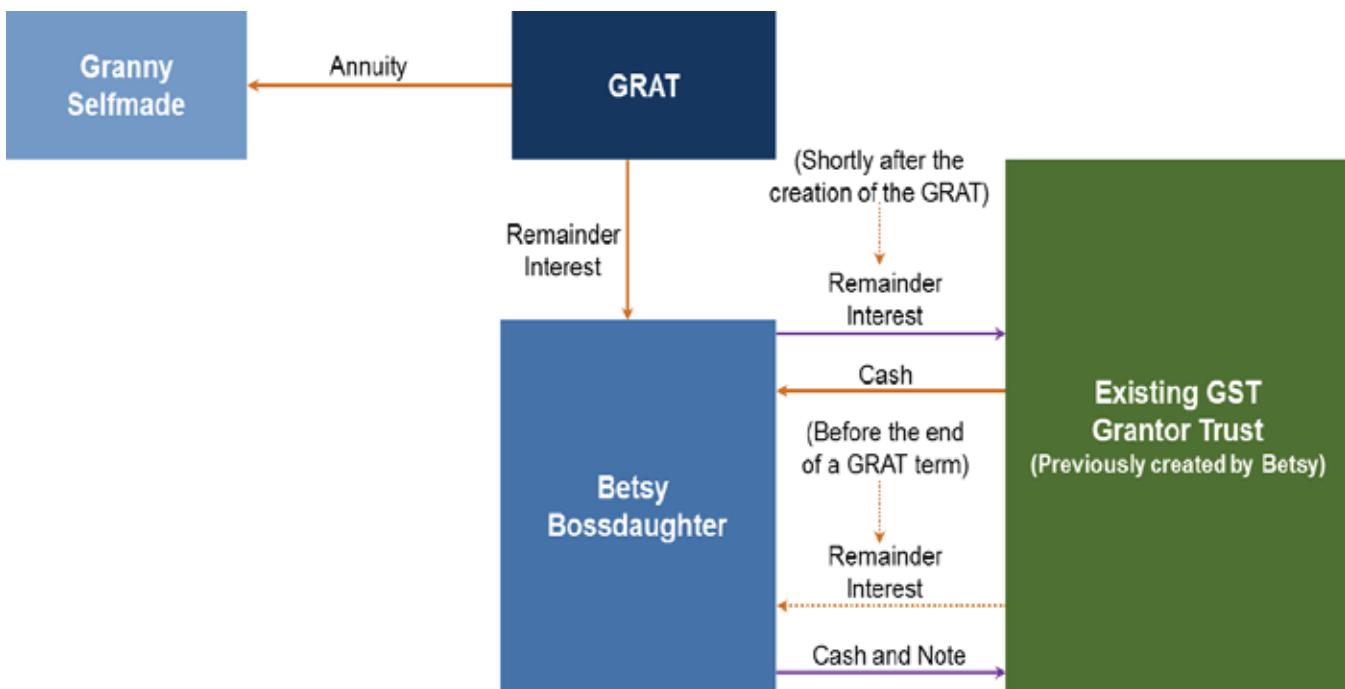
*Example 8: Granny Selfmade Creates a GRAT That, Because of the Non-Skip Remainderman's Actions, Indirectly Benefits a Generation-Skipping Trust*

*Granny Selfmade creates a GRAT with a retained annuity amount that results in a very low gift for gift tax purposes to the remainderman, her daughter, Betsy Bossdaughter. The terms of the trust agreement creating the GRAT provide that if Granny survives the two-year term of the GRAT, but Betsy does not survive the term of the GRAT, the remaining proceeds of the GRAT, if any, are to pass to Betsy's two children, Bob and Brenda Bossdaughter.*

*Betsy is grateful for the creation of the GRAT by her mother, but she feels that her mother has already done enough estate planning for her benefit. Betsy is interested in transferring wealth to her children. Several years ago Betsy made an independent gift to a generation-skipping trust in which the primary beneficiaries were her children, Bob and Brenda. The generation-skipping trust is an intentionally defective grantor trust. In the early days of the GRAT, while the actuarial value of the remainder interest is very low, Betsy, for full and adequate consideration, sells her remainder interest to that existing GST trust she created.*

*The GRAT is very successful. Before the end of the two-year term (or ETIP period) Betsy decides to buy back the remainder interest for full and adequate consideration (perhaps with a seller-financed note). Thus, on termination of the GRAT, Betsy is once again, the only remainderman beneficiary. On termination of the GRAT, Betsy satisfies any note she owes to the existing GST grantor trust with assets she received from the GRAT.*

The technique is illustrated below:



Granny asked her tax advisor, Pam Planner, whether she owes any generation-skipping transfer taxes on termination of the GRAT because of Betsy's actions.

## (2) Advantages of the technique.

Before Pam, or anyone, can answer this question, certain key concepts must be understood in addition to the applicability of the ETIP rules. What is a “transfer” for purposes of Chapter 13? In certain contexts “transfer” is shorthand for “generation-skipping transfer”, which is a defined term. The generation-skipping transfer is one of the three defined GST taxable events: taxable termination, taxable distribution, or direct skip. However, in certain other contexts of Chapter 13, “transfer” refers to the original transfer of property establishing a trust. The transferor, for generation-skipping tax purposes is “the individual with respect to whom property was most recently subject to federal estate or gift tax.” See Treas. Reg. §26.2652-1(a)(1).

Another area where it is important, under Chapter 13, to determine whether a generation-skipping tax transfer has occurred is determining the inclusion ratio when additional transfers are made to a trust. Any addition requires a recompilation of the trust’s applicable fraction and, thus, its inclusion ratio and requires allocation of GST exemption to preserve a zero inclusion ratio. Treas. Reg. §26.2642-4 seems to suggest that no addition to a trust can occur without a gift or an estate taxable transfer. A transfer for full and adequate consideration is not such a transfer and should not be an addition.

Under these definitions, Pam Planner advises Granny that there appears to be no transfer that would incur GST tax or require an allocation of GST exemption to avoid tax.

## (3) Considerations of the technique.

Consideration must be given to PLR 200107015. This ruling involved a zeroed-out charitable lead annuity trust (“CLAT”) and a proposed gift assignment by a child who was a one-sixth vested remainderman. The gift would be to a trust, which is a generation-skipping trust with respect to the grantor of the CLAT. The purpose of the ruling was to determine whether the child would be treated as the transferor for GST purposes instead of the grantor of the CLAT. The IRS refused to grant the request of a favorable ruling:

Section 2642(e) provides a special ruling for determining the inclusion ratio for any ‘charitable lead annuity trust.’ Under §2642(e) and the applicable regulations, in the case of a charitable lead annuity trust the applicable fraction (1) the numerator of which is the adjusted generation-skipping transfer tax exemption (‘adjusted GST exemption’), and (2) the denominator of which is the value of all property in the trust immediately after the termination of the charitable lead annuity. The adjusted GST exemption is the amount of GST exemption allocated to the trust increased by an amount equal to the interest that would accrue if an amount equal to the allocated GST exemption were invested at the rate used to determine the amount of the estate or gift tax charitable deduction, compounded annually, for the actual period of the charitable lead annuity. The amount of GST exemption allocated to a charitable lead annuity trust is not reduced even though it is ultimately determined that the allocation of a lesser of GST exemption would have resulted in an inclusion ratio of zero. Under §2642(e)(3), a ‘charitable lead annuity trust’ is defined as any trust providing an interest in the form of a guaranteed annuity for which the transferor is allowed a charitable deduction for Federal estate or gift tax purposes under §§2055 and 2522.

In the absence of §2642(e), little or no GST tax would ever be imposed with respect to certain charitable lead annuity trusts, even if no GST exemption is allocated to the trust. That is, if the value of the assets transferred to the trust was equal to the estate tax charitable deduction allowed with respect to the transfer, then under the general rules of §2642, the inclusion ratio with respect to the trust would be zero and the trust would be exempt from GST tax. Even if the charitable deduction did not equal the value of the transferred assets, an allocation of only a small amount of GST exemption would have resulted in no GST tax. Congress was concerned that allowing the present value of the charitable interest to reduce the denominator of the applicable fraction permitted the leveraging of the GST tax exemption. If the trust assets sufficiently outperform the rate of return assumed in computing the present value of the charitable interest, the amount passing to non-charitable persons can exceed the amount which would have passed to them had there been no charitable interest in the trust. S. Rep. No. 445, 100<sup>th</sup> Cong., 2d Sess. 368 (1988).

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We also note that under the facts presented in the ruling request, the form of the transaction might be disregarded and the series of transactions viewed as the designation by the Trustee of Child A's children as remainder beneficiaries. Under this analysis, Decedent would be treated as the transferor of the entire Trust estate for GST tax purposes. *See Estate of Bies v. Commissioner*, T.C. Memo. 2000-338; *Estate of Cidulka v. Commissioner*, T.C. Memo. 1996-149; *Griffin v. United States*, 42 F. Supp. 2d 700 (W.D. Tex. 1998).

The ruling's basic holding can be viewed as uniquely applicable to the charitable lead annuity trust. However, it is clear that the IRS will look for other opportunities to apply equitable doctrines in similar contexts. Stated differently, the ruling's reasoning could apply just as easily to a GRAT, if the reader substituted the phrase "ETIP rules" for "IRC Section 2642(e)." Using the same logic, the Service could find that a *gift* by a GRAT remainderman is avoidance of the Congressional intent in enacting the ETIP rules. However, would the equitable doctrines inherent in the ruling apply to a *sale* by Betsy in above Example 8? It would appear that the answer should be no.

In using a sale for full and adequate consideration, the issue is not whether Granny or Betsy is the transferor of the property that moves from the GRAT to the dynasty trust. The issue is whether there is an addition to the dynasty trust for GST purposes. There should not be an addition to the dynasty trust for GST purposes when Betsy transfers the remainder interest to the GST trust for full and adequate consideration and when Betsy buys the remainder interest back for full and adequate consideration.

Another hurdle for the IRS is that for property law purposes and gift tax purposes, Granny's only transferee is a non-skip person (Betsy Bossdaughter). It would seem that the IRS, in order to be successful, would have to argue that a generation-skipping tax transfer occurred by Granny when Betsy sold for full consideration the remainder interest to the generation-skipping trust she created, even though you could not determine whether a generation-skipping transfer has occurred until after it was determined if Granny Selfmade survived the annuity term (and at that point, the only beneficiary of the GRAT was a non-skip person). The cumulative hurdle of those positions may be very difficult for the IRS to surmount.

d. The remainder interest in a GRAT that is indirectly held by the grantor of the GRAT is sold for full and adequate consideration to an existing GST grantor trust.

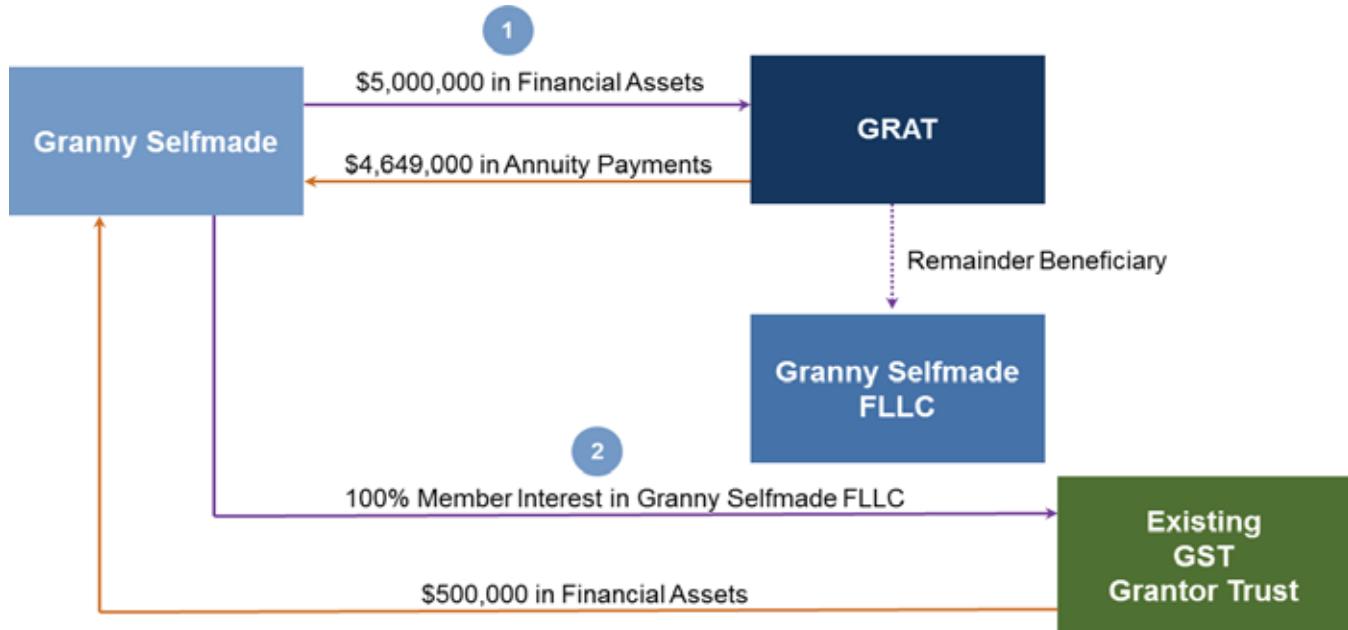
(1) The technique.

Consider the following example:

*Example 9: Granny Transfers a Remainder Interest in a GRAT for Full and Adequate Consideration to a Pre-Existing Generation-Skipping Transfer Trust*

*Granny Selfmade transfers cash and marketable financial assets equal to \$5,000,000 to a two-year GRAT. The GRAT pays an annuity equal to 46.49% at the end of each year at a time*

when the IRS Section 7520 rate is 2.2%. The remainder beneficiary is *Granny FLLC*, which has \$160,000 in other assets. *Granny Selfmade* is the only owner of *Granny FLLC*. Shortly after the creation of the GRAT, *Granny* transfers, for full and adequate consideration, all of her interest in *Granny FLLC* to an existing generation-skipping trust that is also a grantor trust that was created several years ago. *Granny* uses a defined value allocation formula in making that assignment to the existing GST Grantor Trust. The technique is illustrated as follows:



*Granny* files a gift tax return reporting both transactions 1 and 2 above. In the gift tax return *Granny* reports that the transfer in transaction 2 was for full and adequate consideration.

(2) Advantages of the technique.

(a) The technique should avoid gift taxes.

*Granny* should not have any gift tax exposure with transaction 1. The combined value of *Granny*'s retained annuity in the GRAT and *Granny*'s ownership of the FLLC should eliminate any gift. With respect to transaction 2, *Granny*'s sale of her membership in the FLLC will be a gift only if the consideration received is less than the full value of the FLLC.

(b) Assuming the grantor of the GRAT receives full consideration, the technique should avoid all estate taxes and generation-skipping transfer taxes, even if the grantor dies during the term of the GRAT annuity.

IRC Section 2036(a) does not apply if *Granny* receives full consideration. However, if there is even a \$1.00 gift, and if *Granny* dies during the term of the GRAT, all of the value of the GRAT at the time of *Granny*'s death, will probably be brought back into her estate minus the value *Granny* received in transaction 2 (see IRC Section 2043).

- (c) When the GRAT terminates and the existing GST grantor trust receives Granny's FLLC interest, that should not be treated as an addition for purposes of requiring an adjustment to the existing GST grantor trusts inclusion ratio, assuming the existing GST grantor trust pays full consideration for Granny's interest.

*See* discussion *supra* Section IV.C.5.c.(3). If an addition is made to a trust above the trust's payment of consideration for that addition its inclusion ratio is adjusted to reflect the addition. *See* IRC Section 2642(d). However, when a trust with a zero inclusion ratio makes a profitable investment, the receipt of the profit will not change its inclusion ratio.

(3) Considerations of the technique.

- (a) There is no authority that explicitly supports the advantages outlined above, other than the analysis offered in this paper.

The consequence of the analysis offered in this paper being incorrect is to put the grantor back in the same position she would have been in if she had created a conventional GRAT.

- (b) It is crucial for the grantor to have received full consideration in above transaction 2.

In order to make sure the sale of the remainder FLLC is for full consideration, the grantor may wish to consider entering in a defined value allocation assignment when selling to the existing grantor trust.<sup>126</sup>

- (c) Other than the GST consideration, this technique has the same considerations delineated *supra* Section IV.C.3.

- (d) It may be crucial that the remainder interest of the GRAT that is sold has substance and is not a de minimis amount. *See* discussion *supra* Section IV.C.5.e.(3)(b).

- e. The creation of a GRAT for full and adequate consideration.

(1) The technique and its advantages.

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<sup>126</sup> *See* this author's paper, "Planning for the 0.2% as if They Were Part of the 99.8%: Some of the Best Planning Strategies We See That Reduce Both Income Taxes and Estate Taxes," 49 U Miami Heckerling Institute on Estate Planning ¶402.1[C][6] (2015 University of Miami); *also see* this author's paper, "The Art of Donating Your Cake to Your Family and Eating It Too: Current Gift Planning Opportunities Using Strings That Are Not Considered Attached By the Donor," 47 U Miami Heckerling Institute on Estate Planning, ¶602.2[C][5] (2013 University of Miami).

Consider a GRAT that is created with a substantial remainder interest; however, because of a purchase of a remainder interest of the GRAT upon its creation, there is not a gift. That is, instead of making a gift of the remainder interest, what if the grantor of a GRAT sold it for full and adequate consideration to a pre-existing GST grantor trust upon its creation? IRC Section 2036 inclusion does not apply if the grantor dies before the GRAT term ends, and as a consequence, the ETIP limitation may also not apply and the creation of the GRAT may not constitute a transfer to the GST trust. Consider the following example:<sup>127</sup>

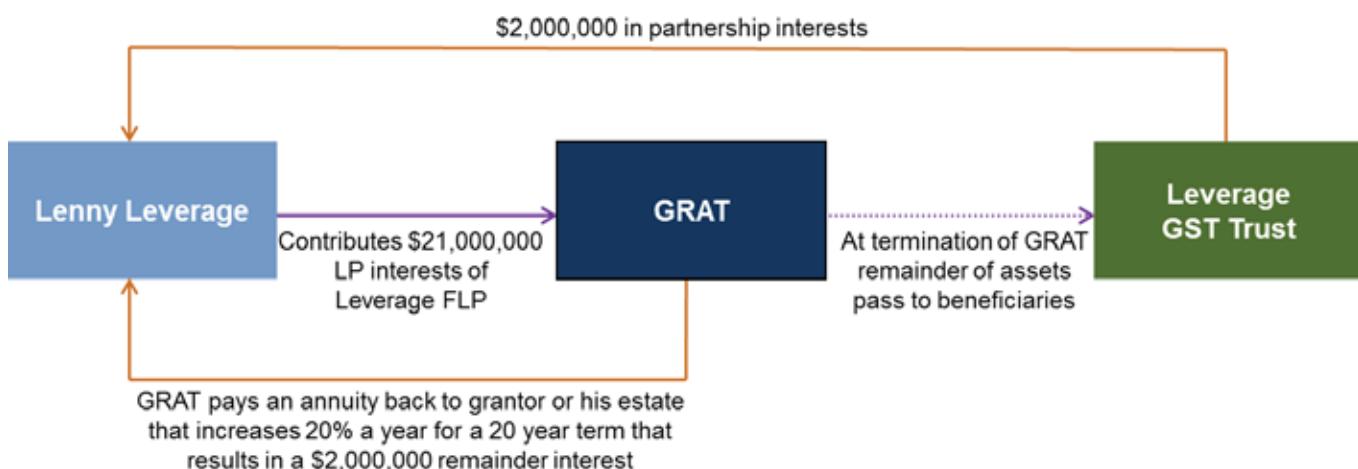
*Example 10: Lenny Leverage Enters into a GRAT with the  
Remainderman Being an Existing Grantor Trust That is a  
Generation-Skipping Transfer Trust, With the Existing Generation-Skipping  
Transfer Trust Purchasing the Remainder Interest for Full Consideration*

Several years ago, Lenny Leverage created a generation-skipping transfer trust that is also a grantor trust. The GST trust and Lenny contributed certain assets to a FLP. Lenny's interest in the partnership, after considering valuation discounts, is worth \$21 million and the GST trust's interest in the partnership is worth \$2,000,000. The GST trust transfers that \$2,000,000 partnership interest to Lenny Leverage in full consideration for Lenny Leverage contributing his \$21 million interest in the FLP to a GRAT that is designed with a defined value formula annuity which increases 20% a year. Lenny (or his estate) will receive that term annuity. The formula produces a remainder value of \$2 million under IRC Section 7520. The liquidation value of the partnership interest that is transferred to the GRAT is \$30 million and the appraised fair market value of the transferred partnership interest is \$21 million (30% discount). The partnership, at that time, has 15 years to operate before it terminates. Lenny has \$1,500,000 outside the partnership. Lenny is 50 years old.

The technique is illustrated below:

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<sup>127</sup> There are other alternative forms of designing a GRAT that is formed for adequate and full consideration. In order to avoid estate tax inclusion of the value of the remaining annuity payments and future estate income taxes, if the grantor does not live past the annuity term, the GRAT annuity payments (which will have to be higher to provide full consideration) could be designed to terminate at the shorter of the grantor's life or the stated term. The GRAT could be designed to be a joint contribution GRAT. In that circumstance, care should be taken to make sure the same assets (e.g., partnership units of the same partnership) are being contributed by the grantor and the GST trust to the GRAT.



(2) Advantages of the technique.

(a) Significant value can be transferred because of the leverage of a GRAT.

Please note the table below, which delineates the amount that is projected to be transferred to Lenny's children, grandchildren and great grandchildren pursuant to this technique in comparison to not doing any further planning with respect to the partnership. The table assumes Lenny's death at the end of year 20, Lenny consumes \$100,000 a year with a 3% inflation rate, an 8% pre-tax rate of return with 2% being taxed at ordinary income rates (35%) and 6% at capital gains rates (15%, with a 30% turnover). Assume that the partnership, at the time of the creation of the purchase GRAT, has only 15 years remaining and that the valuation discount is 30%. *See Schedule 7 attached to this paper.*

**Table 7**

| Technique  | Leverage Children | Leverage GST Trust | Consumption – Direct Cost | Consumption – Investment Opportunity Cost | IRS – Income Tax | IRS – Investment Opportunity Cost | IRS – Estate Tax (at 45%) | Total         |
|--|-------------------|--------------------|---------------------------|---|------------------|-----------------------------------|---------------------------|---------------|
| No Further Planning; Bequeaths Estate To Family  | \$55,282,583      | \$13,317,021       | \$2,687,037               | \$3,022,654                               | \$20,916,430     | \$19,680,241                      | \$45,231,204              | \$160,137,171 |
| Hypothetical Integrated Income and Estate Tax Plan With a Partnership and GRAT; Bequeaths Estate To Family | \$9,687,257       | \$98,772,116       | \$2,687,037               | \$3,022,654                               | \$20,778,989     | \$17,263,179                      | \$7,925,938               | \$160,137,171 |

(b) The creation of the joint purchase GRAT is not subject to the ETIP rules and the creation of the GRAT does not constitute a transfer to the GST trust.

If Lenny died during the 20-year term of the GRAT, the GRAT property will not be includible in his gross estate.<sup>128</sup> Only the remaining actuarial value of the unpaid annuity amounts of the GRAT would be included under IRC Section 2033.

What would be the results, if the GRAT was for the shorter of 20 years or Lenny's death? The annuity amounts would be higher. However, that technique would have income tax and estate tax advantages if Lenny died during the 20 years. See the results below and see attached Schedule 7a:

**Table 7a**

| Technique  | Leverage Children | Leverage GST Trust | Consumption – Direct Cost | Consumption – Investment Opportunity Cost | IRS – Income Tax | IRS – Investment Opportunity Cost | IRS – Estate Tax (at 45%) | Total         |
|--|-------------------|--------------------|---------------------------|---|------------------|-----------------------------------|---------------------------|---------------|
| No Further Planning; Bequeaths Estate To Family  | \$55,282,583      | \$13,317,021       | \$2,687,037               | \$3,022,654                               | \$20,916,430     | \$19,680,241                      | \$45,231,204              | \$160,137,171 |
| Hypothetical Integrated Income and Estate Tax Plan With a Partnership and GRAT; Bequeaths Estate To Family | \$19,236,810      | \$81,703,110       | \$2,687,037               | \$3,022,654                               | \$20,485,173     | \$17,263,179                      | \$15,739,208              | \$160,137,171 |

**(3) Considerations of the technique.**

(a) It is crucial to avoid valuation issues with this technique.

The purchase price for the remainder interest must be consistent with the valuation assumptions of the GRAT. Thus, using “apples to apples”, such as partnership units in the same partnership, will facilitate adequate and full consideration being paid for the remainder interest in the GRAT.

<sup>128</sup> See *Wheeler v. United States*, 116 F.3d 749 (5th Cir. 1997); *Estate of D'Ambrosio v. Commissioner*, 101 F.3d 309 (3d Cir. 1996); *Estate of Magnin v. Commissioner*, 183 F.3d 1074 (9th Cir. 1999); *contra, Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd*, 897 F.2d 516 (Fed. Cir. 1990).

(b) There could be abusive situations where the remainder interest is very small and the logic of the *Wheeler*, *D'Ambrosio* and *Magnin* cases would not be applied.

However, under the facts assumed under this example, the remainder interest is significant and would seem to be analogous to the remainderman values considered in the Circuit Court cases cited in footnote 125 of this paper.

(c) If the GRAT is for a term of years with the GRAT annuity payable to the grantor or his estate and the grantor dies before the end of the term, there could be unfavorable estate tax and income tax consequences.

The remaining annuity payments will be included in the grantor's estate under IRC Section 2033. The remainder GST trust will receive no income tax deduction for the annuity payments made to the grantor's estate, but part of the annuity payments will be IRD income to the estate.

D. A Gift Tax Free Transfer to a Grantor Trust: The Remainder Purchase Marital Trust Technique.

1. The technique.

The Remainder Purchase Marital Trust, which is sometimes referred to as the "RPM Trust," involves a transfer of assets to a trust in which donor's spouse has an income or annuity interest for a specified term or life (which also makes the trust a grantor trust to the donor). The remainder of the RPM Trust passes to a separate grantor trust (the "Remainderman Trust"), which could be a generation-skipping trust. The transfer to the trust is gift tax-free because (i) the spouse's income or annuity interest in the RPM Trust qualifies for the gift tax marital deduction, and (ii) the Remainderman Trust pays the donor the actuarial value of the remainder interest when the RPM Trust is created. The RPM Trust assets are not included in either the donor's estate (because the donor has no retained interest in the trust) or the spouse's estate (because the spouse does not have a general power of appointment and there is no QTIP election) at their subsequent deaths. This technique has been extensively described by David Handler.<sup>129</sup>

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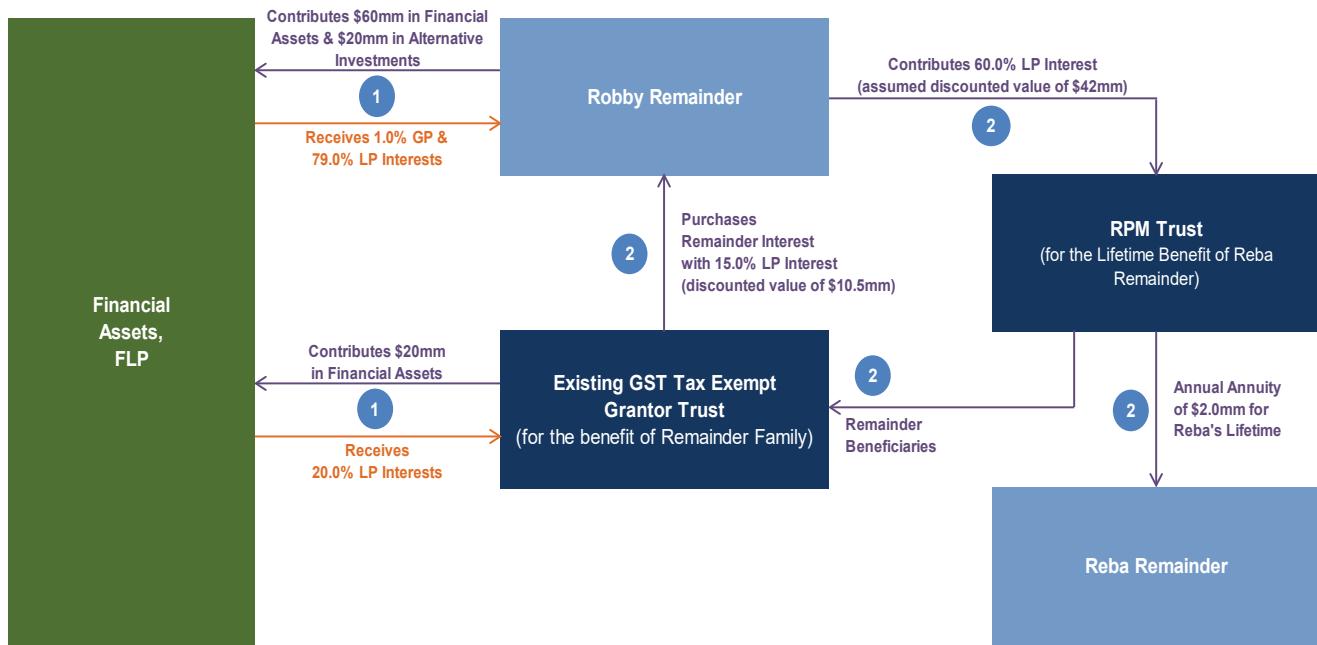
<sup>129</sup> David A. Handler & Deborah V. Dunn, "GRATs and RPM Annuity Trusts: A Comparison," 29 Tax Mgmt. Est., Gifts & Tr. J. 4 (July 8, 2004) and Handler and Dunn, "RPM Trusts: Turning the Tables on Chapter 14," 139 Trusts and Estates 31 (July 2000).

Example 11: Creation of a Remainder Purchase Marital Trust

*As part of Robby Remainder's estate planning, he wishes to use an existing GST grantor trust and the gift tax marital deduction to facilitate a transfer to a trust for the benefit of his wife, Reba Remaining, which upon her death will pass to the trustee of that existing GST grantor trust. Previously, Robby has contributed assets to a GST grantor trust, which became a partner in a FLP ("Financial Assets, FLP"). Robby contributed \$20,000,000 in financial assets to the trust, which the trustee invested, for pooling of interest reasons, into a partnership and received a 20% interest. Robby contributed \$60,000,000 of his financial assets and \$20,000,000 of his alternative investments into the partnership and received a 2.6% general partnership and a 79% limited partnership interest. At a later date, Robby contributed 60% of his limited partnership interest to a trust (the "RPM Trust") for the benefit of his wife, Reba Remainder, which was to last during her lifetime and the existing GST grantor trust becomes the Remainderman Trust by paying Robby 3/10 of that amount (a 15% partnership interest) in exchange for the remainder interest in the RPM Trust. Under the terms of the trust Reba is to receive an annual annuity, which will produce a remainder value equal to 3/10 of the fair market value of the RPM Trust. There is "price adjustment" language in determining the annuity amount so that the remainderman will pay the correct amount. Assuming at the time of the creation of the RPM Trust, the IRC Section 7520 rate is 2.6%, Reba is 60 years of age and that the partnership valuation discount is 30%, the annual annuity should be \$2,017,740. It is assumed that over a 25-year period the financial assets will annually earn 7.4% (with 0.6% being taxed at ordinary rates, 2.4% being tax free and 4.4% being taxed at capital gains rates with a 30% turnover rate). It is assumed that over a 25-year period the alternative investments will annually earn 8% (with 7% being taxed at ordinary rates and 1% being taxed at capital gains rates with a 30% turnover rate). Upon her death, all of the assets of the RPM Trust (the 60% limited partnership interest and any cash that has accumulated in the trust from distributions that exceeded \$2,017,740) are to pass to the existing GST grantor trust. If Reba Remainder lives 25 years, the GST grantor trust will receive 60% of a partnership that has \$260,396,939 in assets and an additional \$71,334,397 in financial assets that has accumulated in the RPM Trust.*

*The desired result of this technique is that there will be no gift taxes on the creation of the RPM Trust because of the marital deduction. The terminable interest rule will not apply because adequate consideration has been paid for the remainder interest and the requirements of IRC Section 2702 are met. There will be no estate taxes on Reba's death because she is not the grantor of the RPM Trust, the QTIP election has not been made and Reba does not possess a general power of appointment.*

*An illustration of the technique is below:*



It is important that Reba Remainder only has a straight income or annuity interest in the RPM Trust. If she has the right to receive distributions under an ascertainable or discretionary standard, her interest would be hard to value and it would be very difficult to effectuate the technique.

IRC Section 2523(b)(1) provides that no gift tax marital deduction is allowed if the spouse receives a life estate or other interest in a trust and upon termination of the trust the trust assets pass to someone else “for less than adequate and full consideration in money or money’s worth” (the so-called “terminable interest rule”). Thus, in order to not run afoul of the terminable interest rule, it is crucial that full consideration be paid for the remainder interest of the RPM Trust. The RPM Trust could provide that all of the income or an annuity amount goes to the grantor’s spouse. Generally, at times of high interest rates it is more advantageous to provide income interest for the donor spouse and in times of low interest rates, it is more advantageous to provide for an annuity for the donor’s spouse. The Remainderman Trust, unless it is very clear that it is an old and cold trust, should be created by someone other than the grantor (in order not to run afoul of the terminable interest rule) or the beneficiary of the RPM Trust in order to prevent the application of IRC Section 2702 under the joint purchase rules. This Example 11 assumes that the existing grantor trust that becomes the Remainderman Trust is clearly an old and cold trust.

See the table below (also see attached Schedule 8) which summarizes the benefit of the RPM Trust under the facts of above Example 11.

**Table 8**

| Remainder Beneficiaries                    |                            | Consumption   |                             | IRS Income Tax |                             | Tax Liability of Estate              |                           | Total        |
|--|----------------------------|---------------|-----------------------------|----------------|-----------------------------|--------------------------------------|---------------------------|--------------|
| Children                                   | Children and Grandchildren | Direct Cost   | Investment Opportunity Cost | Direct Cost    | Investment Opportunity Cost | Embedded Capital Gains Tax Liability | IRS Estate Tax (at 40.0%) |              |
| <b>25-Year Future Values</b>               |                            |               |                             |                |                             |                                      |                           |              |
| No Further Planning                        | \$141,782,289              | \$118,506,275 | \$42,697,205                | \$62,000,386   | \$63,050,023                | \$79,122,601                         | \$2,335,519               | \$95,081,526 |
|  | \$260,288,564              |               | \$104,697,591               |                | \$142,172,625               |                                      | \$97,417,045              |              |
| Hypothetical Technique                     | \$68,455,423               | \$254,697,332 | \$42,697,205                | \$62,000,386   | \$64,849,695                | \$79,122,601                         | \$4,784,019               | \$27,969,163 |
|  | \$323,152,755              |               | \$104,697,591               |                | \$143,972,296               |                                      | \$32,753,182              |              |
| <b>Present Values (discounted at 2.5%)</b> |                            |               |                             |                |                             |                                      |                           |              |
| No Further Planning                        | \$76,476,032               | \$63,921,169  | \$23,030,471                | \$33,442,425   | \$34,008,589                | \$42,677,986                         | \$1,259,757               | \$51,286,080 |
|  | \$140,397,202              |               | \$56,472,895                |                | \$76,686,576                |                                      | \$52,545,837              |              |
| Hypothetical Technique                     | \$36,924,211               | \$137,381,344 | \$23,030,471                | \$33,442,425   | \$34,979,315                | \$42,677,986                         | \$2,580,455               | \$15,086,303 |
|  | \$174,305,555              |               | \$56,472,895                |                | \$77,657,302                |                                      | \$17,666,758              |              |

## 2. Advantages of the technique.

- a. Tax advantages of creating a grantor trust and transferring assets to the grantor trust with significant lifetime leverage, which could result in a significant amount being transferred to the remainder trust.
- b. The near term death of the grantor, or the grantor's spouse, generally does not affect the technique like the death of a grantor of a GRAT.

If the grantor should pass away before the end of the term of the RPM Trust, assuming the grantor has been paid full consideration<sup>130</sup> to create the RPM Trust, there should not be any gift tax or estate tax consequences to the grantor. If the donor's spouse should die before the end of a term-of-years RPM Trust, the amount included in the spouse's estate should only be the actuarial value of the remaining annuity payments.

<sup>130</sup> Of course, full consideration does not have any estate tax significance here, where the grantor has no retained interest or power. It is highly significant in preventing a gift by qualifying the spouse's interest under the terminable interest rule and offsetting the transfer of the remainder.

- c. The appreciation of the assets will be out of the grantor's estate and the spouse of the grantor's estate.

Only the consideration received by the grantor, to the extent it has not been spent during the grantor's lifetime, will be included in his estate. The appreciation associated with the purchase of the Remainderman Trust (using that consideration) will not be included in the grantor's estate, assuming full consideration was paid for the creation of the RPM Trust.

- d. The grantor and the grantor's spouse will have available for their consumption needs the consideration paid by the Remainderman Trust and the distributions paid pursuant to the beneficial provisions of the RPM Trust (and perhaps the Remainderman Trust).

As illustrated in Example 11, significant assets could be eventually transferred to a generation-skipping trust for the benefit of the grantor's spouse and family under this technique. Additionally, the grantor will have the consideration originally paid to the grantor by the GST Remainderman Trust for the creation of the RPM Trust and the grantor's spouse will have available cash flow under the terms of the RPM Trust. A significant advantage of this technique is that a significant transfer of wealth escapes the estate tax, yet cash flow will be available to the donor and the donor's spouse for their consumption needs with respect to the transfer. In Example 11, upon creation of the RPM Trust (ignoring valuation discounts), 60% of the partnership (or \$60,000,000) is designed to pass to the GST Trust, yet only 5% of the \$100,000,000 partnership (or \$5,000,000) is not available to either Robby or Reba.

- e. There is more flexibility in the design of the structure in comparison to a GRAT because IRC Section 2702 does not apply to the technique and it is easier to do leveraged GST planning in comparison to a GRAT.

IRC Section 2702 does not apply because the donor does not retain an interest in either the RPM Trust, or the Remainderman Trust. The joint purchase rule of IRC Section 2702 is not applicable because the donor's spouse has not paid any consideration for her term interest. *See* Treas. Reg. § 25.2702-4(c).<sup>131</sup> There is an exception under the joint purchase rule for joint trusts for family members, if the term interest is donated. If this exception to the joint purchase rule did not exist, the spouse would be treated as making a large taxable gift under IRC Section 2702 whenever an *inter vivos* QTIP trust is created.

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<sup>131</sup> The Regulation says: "For purposes of this paragraph (c), the amount of the individual's gift will not exceed the amount of consideration furnished by that individual for all interests in the property." *Emphasis added.* If the spouse is a beneficiary of the Remainderman Trust, will (s)he be deemed to have furnished a part of the consideration paid by the Remainderman's Trust for its remainder interest in the RPM, and therefore to have made a taxable gift to that extent? It would appear for state law property purposes (if that is determinative) that (s)he would not be considered as furnishing any consideration under those circumstances.

If IRC Section 2702 does not apply, then there may be more flexibility in designing the trust in comparison to a classic GRAT. For instance, a more significant appreciation than 20% a year could occur over the term of years in designing the annual increases in the annuity amount. That could be a very valuable advantage for an asset that is anticipated to have very low cash flow in the early years and significant cash flow in the later years of its existence (e.g., as a closely held business interest). The trustee of the RPM Trust could pay the annuity amount with notes. If it is a term RPM Trust the term could be one year.

Since the ETIP rules do not apply to the technique, the Remainderman Trust may be a generation-skipping trust. The growth of the RPM Trust assets could exceed what the growth of the GST trust would have been without the purchase of the remainder interest.

- f. The technique could also serve as a qualified personal residence trust (QPRT) substitute and could be a very good vehicle for planning for art.

The RPM Trust could be an income only trust for the life of the grantor's spouse or a set number of years. The RPM Trust and the Remainderman Trust could be funded with cash and near cash that is easy to value. For example, assume the donor's spouse (Alice Artlover) is 60 years of age and the IRC Section 7520 rate is 2.6%. Assume the donor (Alan Artlover) owns \$80,000,000 in financial assets, a \$10,000,000 vacation home and \$20,000,000 in artwork. An existing GST grantor trust has \$20,000,000 in financial assets. In consideration for a payment of \$20,000,000 in cash by the GST remainderman, the donor (Alan Artlover) contributes \$13,667,200 to the income or life estate only RPM Trust for the benefit of Alice Artlover, for as long as she lives. After the RPM Trust is funded, Alan Artwork could loan and sell (pursuant to a defined allocation assignment) \$56,000,000 in financial assets, his \$10,000,000 vacation home and his \$20,000,000 in artwork for a nine-year \$86,000,000 note that pays the midterm AFR rate of 2.08%. In future years, the note could be refinanced. The technique would have a mortality advantage over a qualified personal residence trust under IRC Section 2702 ("QPRT") because there is no mortality risk, if the donor or the spouse dies during the term. Limitations under a QPRT for what constitutes a personal residence and the two-residence limit also would not apply. After the RPM Trust ends the donor (if then living) could purchase the house and the art back from the Remainderman Trust (designed to be a grantor trust), which is prohibited by the QPRT rules. Unlike a QPRT, the RPM Trust would not have to be converted to an annuity trust if the residence is sold during the term of the RPM Trust.

There should not be any capital gains taxes associated with the donor's sale of the personal residence, or the art, because the RPM Trust will be treated as a grantor trust to the donor under IRC Section 677(a).

There may be gift tax consequences if the consideration received for the RPM Trust is not equal to the fair market value of the donor's residence or art that is sold. The use of a defined value allocation formula in the sale assignment may ameliorate the gift tax concern. If there is not a gift by the donor to the RPM Trust because the consideration is adequate, neither the residence nor the art will be included in the donor or the donor spouse's estate under IRC Section 2036. IRC Section 2036 should not apply to the donor because the donor does not have any

interest in the RPM Trust. Staying married to one's spouse should not constitute retaining an interest in a trust solely for the spouse's benefit.<sup>132</sup> IRC Section 2036 will not apply to the donor's spouse because the donor's spouse is not the transferor of the residence or the art.

If the donor's spouse lives 25 years, significant estate taxes could be saved and a significant amount can be transferred to the GST trust. *See* the table below and attached Schedule 9.

**Table 9**

| Artlover Beneficiaries                     |                          | Consumption   |                             | IRS Income Tax |                             | Tax Liability of Estate              |                           | Total         |
|--|--------------------------|---------------|-----------------------------|----------------|-----------------------------|--------------------------------------|---------------------------|---------------|
| Children                                   | Children & Grandchildren | Direct Cost   | Investment Opportunity Cost | Direct Cost    | Investment Opportunity Cost | Embedded Capital Gains Tax Liability | IRS Estate Tax (at 40.0%) |               |
| <b>25-Year Future Values</b>               |                          |               |                             |                |                             |                                      |                           |               |
| No Further Planning                        | \$239,463,053            | \$127,666,275 | \$64,628,987                | \$84,587,881   | \$51,988,337                | \$62,417,802                         | \$2,335,519               | \$168,175,369 |
|  | \$367,129,328            |               | \$149,216,868               |                | \$114,406,138               |                                      | \$170,510,888             |               |
| Hypothetical Technique                     | \$81,697,285             | \$387,802,991 | \$64,628,987                | \$84,587,881   | \$53,390,206                | \$62,417,802                         | \$5,606,547               | \$61,131,523  |
|  | \$469,500,276            |               | \$149,216,868               |                | \$115,808,007               |                                      | \$66,738,070              |               |
| <b>Present Values (discounted at 2.5%)</b> |                          |               |                             |                |                             |                                      |                           |               |
| No Further Planning                        | \$129,164,118            | \$68,861,987  | \$34,860,267                | \$45,625,907   | \$28,042,020                | \$33,667,575                         | \$1,259,757               | \$90,712,211  |
|  | \$198,026,105            |               | \$80,486,174                |                | \$61,709,594                |                                      | \$91,971,968              |               |
| Hypothetical Technique                     | \$44,066,747             | \$209,177,284 | \$34,860,267                | \$45,625,907   | \$28,798,175                | \$33,667,575                         | \$3,024,119               | \$32,973,768  |
|  | \$253,244,031            |               | \$80,486,174                |                | \$62,465,749                |                                      | \$35,997,887              |               |

**3. Considerations of the technique.**

**a. It requires a spouse beneficiary.**

Obviously, for this technique to be effectuated the client must be married and the client must be willing to benefit his or her spouse.

**b. The RPM Trust cannot have a divorce clause, but it could be an advantageous technique to use in pre-divorce planning.**

In certain situations, if a divorce is contemplated, it may be advantageous for one of the spouses to create a RPM Trust for the other spouse with the remainder interest being purchased by a grantor trust that was previously created for the couple's descendants. The RPM Trust

<sup>132</sup> *See* Rev. Rul. 70-155, 1970-1 C.B. 189, which contains this ending paragraph:

Continued occupancy under the facts stated above may be distinguished from the husband-wife cases involving co-occupancy by the donor with the donee, such co-occupancy, where the donor and donee are husband and wife, does not of itself support an inference of an agreement or understanding as to retained possession or enjoyment by the donor. *Estate of Allen D. Gutchess*, 46 T.C. 554 (1966), acquiescence, C.B. 1967-1, 2.

could be designed to fit the agreed goals of the contemplated divorce division. The additional goal of saving future transfer taxes may also be achieved.

c. It is crucial that the Remainderman Trust pay full consideration.

This technique is only viable, if easy to value assets are used, or proportionate interests in the same entity are used. Otherwise, as discussed above, even a small gift could cause this technique to be potentially fatal under IRC Section 2036, because of the inadequacy of the offset under IRC Section 2043. More importantly, if a small gift is involved, the RPM Trust would not qualify for the gift tax marital deduction because of the terminable interest rule.

d. The step transaction doctrine could apply.

If the Remainderman Trust is funded by the Grantor of the RPM Trust, it is very important that the Remainderman Trust be an old and cold trust at the time it purchases its remainder interest. It needs to be funded independent of the RPM Trust transaction so that the remainder interest in the RPM is deemed transferred for full consideration: absent full consideration for the remainder, the gift tax marital deduction may not be allowed for the transfer to the spouse of the term interest in the RPM, because the nondeductible terminable interest rule may be deemed to apply.

e. The need for “substance” with respect to the purchase by the Remainderman Trust.

While an annuity trust can be designed whereby the remainder interest has a very small value (e.g., \$1,000), it may be important that there be much greater substance to the remainder purchase in order to be supported by existing case law. The cases that have supported the proposition that IRC Section 2036 does not apply to purchases of remainder interests have all involved substantial purchased remainders.

f. It is crucial that the remainder and term interests in the RPM Trust be transferred simultaneously.

If the remainder interest is transferred before the term interest, or vice versa, IRC Section 2702 will apply to the transfer of the remainder interest, resulting in a taxable gift equal to the value of the term interest. One way to achieve the desired simultaneity is to create the RPM Trust as a revocable trust that becomes irrevocable upon receipt of the consideration from the Remainderman Trust.

- g. The interest on the note received by the selling spouse will be taxable income to that selling spouse and there will be a corresponding deduction to the spouse who created the grantor trust.

The Tax Court has held that because interest is not “gain,” subject to non-recognition under IRC Section 1041, the interest payments are includable in the selling spouse’s income.<sup>133</sup> The character of the interest paid by the grantor trust and the deductibility of the interest payments by the selling spouse is based on the property transferred by the selling spouse in the transaction. The Tax Court rejected the Service’s argument that any interest paid under a debt between spouses should be automatically characterized as personal because it relates to a transfer between spouses.<sup>134</sup>

- h. The RPM transaction will only be a profitable transaction to the Remainderman Trust if the assets subject to the remainder purchase grow faster than what the consideration utilized by the Remainderman Trust would have otherwise increased.

The transaction will not be a profitable transaction for the Remainderman Trust unless the assets that are subject to the RPM transaction grow faster than the assets would have otherwise grown if it had been held by the Remainderman Trust. Like many estate planning techniques, the success of the technique depends on the prudence of the investments subject to the technique.

**E. The Gifting and Selling Low Basis Assets to a Grantor Trust Where an Older Generation is a Beneficiary and is Subject to an Older Generation’s General Power of Appointment and Estate Taxes (“UPIDGT”) Technique.**

A taxpayer could gift cash and then later sell some of his low basis assets (for adequate and full consideration) to a grantor trust in independent transactions. The beneficiaries of the trust could be the taxpayer’s descendants and an older generation beneficiary, such as a parent. The older generation beneficiary could be given a general power of appointment that will be structured to include those trust assets in his or her estate. If the grantor first gifts high basis cash to the trust, IRC Section 1014(e) should not apply to that gift of cash because it is not a low basis asset. The sale of low basis assets could be for a recourse, unsecured note in which both the trustee and the older generation beneficiary are personally liable. A sale price that is equal to the fair market value of the low basis assets, perhaps pursuant to a defined value allocation assignment, should also circumvent IRC Section 1014(e). For a discussion of defined value assignments *see supra* Section IV.A.3.a.(12). If the sale price is equal to the value of the low

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<sup>133</sup> *Cipriano v. Commissioner*, T.C. Memo 2001-157, aff’d 91 AFTR 2d 2003-608 (3<sup>rd</sup> Cir. 2003).

<sup>134</sup> *Seymour v. Commissioner*, 109 T.C. 279 (1997) (qualified residence interest); *Armacost v. Commissioner*, T.C. Memo 1998-150 (investment interest).

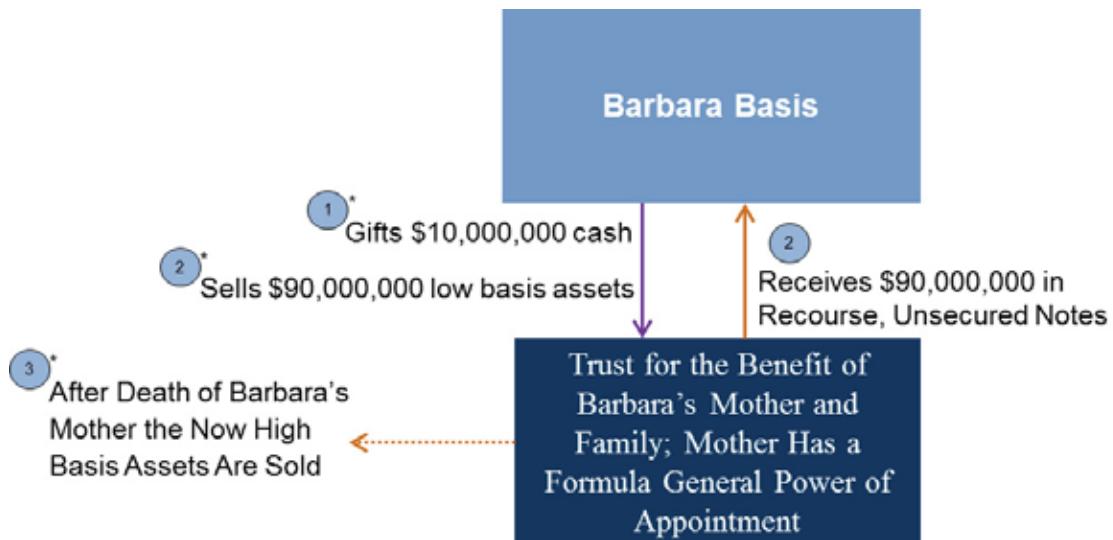
basis asset there is not a gift and IRC Section 1014(e) does not apply, even if the older generation beneficiary dies within one year.

If the older generation beneficiary's estate is small, that general power of appointment may not result in any estate taxes being assessed against his estate. The general power of appointment could be designed so that it may not be exercised unless approved by a non-adverse party such as an independent trustee. Consider the following example:

*Example 12: Barbara Basis Creates a UPIDGT for the Benefit of Her Mother, Gmom Basis, and Her Family and Makes Certain Sales to That Trust*

*In separate and distinct transaction (“Transaction 1) Barbara contributes \$1,000,000 in cash to a trust that is a grantor trust for income tax purposes. Barbara’s mother, Gmom Basis, is the initial beneficiary and is given a formula general power of appointment over the trust. The formula could be drafted to include that amount in Gmom Basis’ estate that does not result in an estate tax for her estate. Barbara, at a later time (Transaction 2) sells \$9,000,000 in low basis property to that trust, pursuant to a defined value allocation formula for a recourse note in which both the trust and Gmom Basis are personally liable. The recourse note is unsecured. After Gmom’s death (Transaction 3), the trustee of the trust sells the now high basis assets and reinvests the proceeds in new assets.*

The technique is illustrated below:



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

1. Income tax and basis enhancing advantages of the UPIDGT technique.
  - a. This technique has the same advantages as a SIDGT.

See discussion *supra* IV.A.3.a.(1), (2) (3), (4) and (5).

- b. The assets of the trust will receive a step-up in basis on the older generation beneficiary's death equal to the fair market value of the assets, if net value rule of treas. reg. §2053-7 does not apply.

The non-depreciable trust assets could be sold after the older generation beneficiary's death and reinvested without capital gains tax consequences.

2. Transfer tax advantages of the UPIDGT technique.

- a. The assets of the trust may be generation-skipping tax protected.
- b. The older generation beneficiary may not have to pay estate taxes because of her general power of appointment, if her then available unified credit exceeds the net value of the trust.
- c. Also consider the income and transfer tax advantages that could accrue if the older generation exercises her testamentary formula general power of appointment in favor of a BDOT in which the younger generation creator of the UPIDGT is the initial beneficiary. *See infra* Section VI.B.

This technique is discussed in further detail below. That exercise of the general power of appointment must be independent and there must not be any prior understanding that the older generation would so exercise that power.

- d. A BDOT could become, under those circumstances, an ideal trust for the younger generation (Barbara) to sell her individual assets to the BDOT, or the younger generation could use the LAIDGT technique with that BDOT.

3. Considerations of the UPIDGT technique.

- a. The grantor of the trust will still have a low basis in his or her note upon the death of the older generation beneficiary.

Even though the assets of the trust will receive a step-up in basis on the older generation beneficiary's death, the grantor's note does not. Under the logic of Revenue Ruling 85-13, the note does not exist as long as the grantor status of the trust is maintained. After the older generation beneficiary's death, the note may be satisfied, without tax consequences, with the now higher basis assets owned by the trust.

- b. The older generation beneficiary could exercise his or her general power of appointment in an unanticipated way.

That possibility could perhaps be mitigated by requiring that an independent, non-adverse trustee approves any exercise of a general power of appointment before it is effective. This veto power seems consistent with IRC Section 2041(b)(1)(c)(ii), which says the power is a general

power unless the veto right is held by someone “having a substantial interest in the property, subject to the power, which is adverse to exercise of the power in favor of the decedent.”

- c. Many of the same considerations for the use of a grantor trust and a sale to a grantor trust would also be present for this technique.

These considerations are discussed in further detail above.

- d. The effect of IRC Section 1014(e) must be considered, if cash is not given and low basis assets are used to capitalize the trust.

Any property that a decedent received by gift within one year prior to death if the decedent bequeaths the property back to the donor. The decedent's pre-death basis in such property will carry over to the donor-legatee, as provided by IRC Section 1014(e):

“Appreciated property acquired by decedent by gift within 1 year of death.

- (1) In general.

In the case of a decedent dying after December 31, 1981, if –

- (A) **appreciated property** was **acquired** by the decedent by **gift** during the 1-year period ending on the date of the decedent's death, and
- (B) such property is **acquired from the decedent** by (or **passes from** the decedent to) the **donor** of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.

- (2) Definitions.

For purposes of paragraph (1) -

- (A) Appreciated property

The term “appreciated property” means any property if the fair market value of such property on the day it was transferred **to the decedent** by gift exceeds its adjusted basis.

- (B) Treatment of certain property sold by estate

In the case of any appreciated property described in subparagraph (A) of paragraph (1) **sold** by the **estate** of the decedent or by a **trust** of which the decedent was the grantor, rules similar to the rules of paragraph (1) shall apply **to the extent** the donor of such property

(or the spouse of such donor) is entitled to the proceeds from such sale.” (Emphasis added).

If the donor is a beneficiary of a new trust created after the death of the donee by the donee’s exercise of a power of appointment, there may not be a step-up of the trust assets with respect to the donor’s actuarial interest in the trust. If the donor’s interest is purely discretionary in a new trust created by the older generation’s exercise, IRC Section 1014(e) may not apply even if the older generation beneficiary dies within one year of the donor’s creation of the grantor trust. Another key exception to the application of IRC Section 1014(e) is whether the decedent acquired any part of the included low basis assets by “gift.” If the decedent acquired the asset by sale, or by part sale-part gift, it would appear that the percentage of the asset acquired by sale should not be subject to IRC Section 1014(e). If the donor does not have a high basis asset, or cash, to initially capitalize the trust, the donor may wish to borrow cash to initially capitalize the trust.

- e. Is grantor trust status lost for the original grantor when the older generation beneficiary dies and the trust assets are included in the beneficiary’s estate?

Treas. Reg. § 1.671-2(e)(6) contains an example that would seem to indicate that the grantor trust status would not change, if the older generation does not exercise his or her general power of appointment:

Example 5. G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B’s child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

It should be noted that this consideration should not exist, if the older generation beneficiary exercises her general power of appointment in favor of a BDOT in which the younger generation UPIDGT creator is the initial BDOT beneficiary (see the discussion below), because the BDOT will be a grantor trust to that younger generation creator.

- f. IRC Section 1014(b)(9) needs to be considered for property that has depreciated.

IRC Section 1014(b)(9) (but none of the other paragraphs of IRC Section 1014(b)) limits the basis adjustment for depreciation taken by a taxpayer other than the decedent. If the trust remains a grantor trust as to the younger generation grantor who originally took the depreciation deduction, after the death of the older generation holder of the general power of appointment, then the amount of the basis adjustment might be reduced by the amount of the depreciation deductions allowed to the younger generation grantor prior to the older generation member’s

death.<sup>135</sup> Under certain circumstances, if this technique is to be used with depreciable property, it may make sense to use valuation discount techniques to sell a depreciable asset to a non-grantor trust (in order to lower the tax consequences of the sale to the non-grantor trust). For instance, a depreciable asset held in a partnership that can be discounted for valuation purposes, could be sold to a non-grantor trust under which the older generation has a power of appointment. At a later time, before the death of the older generation general power holder, in a transaction that is independent, the depreciated asset could be distributed from the partnership to the trust, or the partnership could terminate. IRC Section 1014(b)(4) should apply to the depreciated real estate under those circumstances and the depreciated asset should receive a step-up in basis.

## V. SOME OF THE BEST CREATIVE TAX PLANNING TECHNIQUES FOR SPOUSAL GRANTOR TRUSTS.

### A. The Advantages of a Transferor Selling Assets to a Trust That Names the Transferor as a Beneficiary, Gives the Transferor a Testamentary Special Power of Appointment and Under Which the Transferor's Spouse is Considered the Income Tax Owner ("Spousal Grantor Trust").

#### 1. What is the technique?

- a. If the taxpayer is a beneficiary of a spousal grantor trust and holds a power of appointment over its assets, the taxpayer's sale of property to the trust will permit the taxpayer to benefit from the property's future income and appreciation and to direct how others will enjoy it without exposing the property's income or appreciation to estate tax in the estate of either spouse.

Because the spouse will be liable for the income tax attributable to the spousal grantor trust's investment income, the value of the property in the trust will be able to generate tax free returns for its beneficiaries.<sup>136</sup>

Beneficiary sales to a Spousal Grantor Trust may constitute effective estate planning. It is an attractive estate planning technique because it has the advantages of the SIDGT technique with the additional advantage that the selling taxpayer is also a beneficiary of the trust.

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<sup>135</sup> See Treas. Reg. § 1.1014-6.

<sup>136</sup> The spouse's payment of income taxes on the spousal grantor trust's income will not be subject to gift tax. Rev. Rul. 2004-64. If the taxpayer and the taxpayer's spouse file joint income tax returns, the taxpayer will be able to pay the tax liability if he or she chooses to do so.

Consider the following example:

*Example 13: Ann and Aaron Appointment Wish to Create GST Grantor Trusts and Maintain Maximum Flexibility*

*Ann and Aaron Appointment approach their attorney, Ray Reciprocal, and tell him they would like to transfer their assets in a manner that maintains maximum future flexibility and ensures that there will be no gift tax surprises.*

*Ray suggests they consider creating trusts for each other as discretionary beneficiaries (with different provisions) that will not be considered reciprocal trusts. The trusts will be grantor trusts to the spouse who creates the trust.*

*Aaron creates a limited liability company (Financial Assets, LLC) with \$65,000,000 in business assets and private equity investments and receives a 1.0% managing member interest and a 99.0% non-managing member interest that has a value of \$45,045,000 after considering valuation discounts (Transaction #1 below). It is assumed the valuation discounts for the transfers of non-managing interests is equal to 30%.*

*Aaron creates another limited liability company (Holdco, LLC) with the non-managing member interests in Financial Assets, LLC, non-managing interests in his closely held businesses (which, after discounts, are worth \$99,792,000) along with \$5,000,000 in financial assets in return for a 1.0% managing member interest, a 99.0% non-managing member interest and a \$134,900,000 convertible 9-year note. Due to possible tax considerations with respect to retaining unfettered distributions rights, Aaron may wish to receive 0.01% Class A and 0.99% Class B managing member interests. The Class B managing member interest would control all distribution decisions, including the decision of whether to terminate the LLC. Aaron could give his Class B managing member interest to a trust in which trusted family members or advisors are trustees and under which Aaron could replace the trustees with new trustees as long as the replacement trustees are not related or subordinate. Aaron could retain the Class A managing member interest, which would control all decisions not delegated to the Class B managing member interest, including all investment decisions.*

*The note received by Aaron could be payable over a term of years for a fixed rate or on demand and bear interest at a variable rate which compounds monthly, although actual payments could be less frequent. The note could be convertible to a private annuity based on Aaron's life expectancy or to that amount of non-managing member interests equal to the then outstanding principal of the note at the election of the trustee. The note could be designed to be automatically converted at the death of Aaron to that amount of non-managing member interests equal in value to the then outstanding principal of the note (Transaction 2 below).*

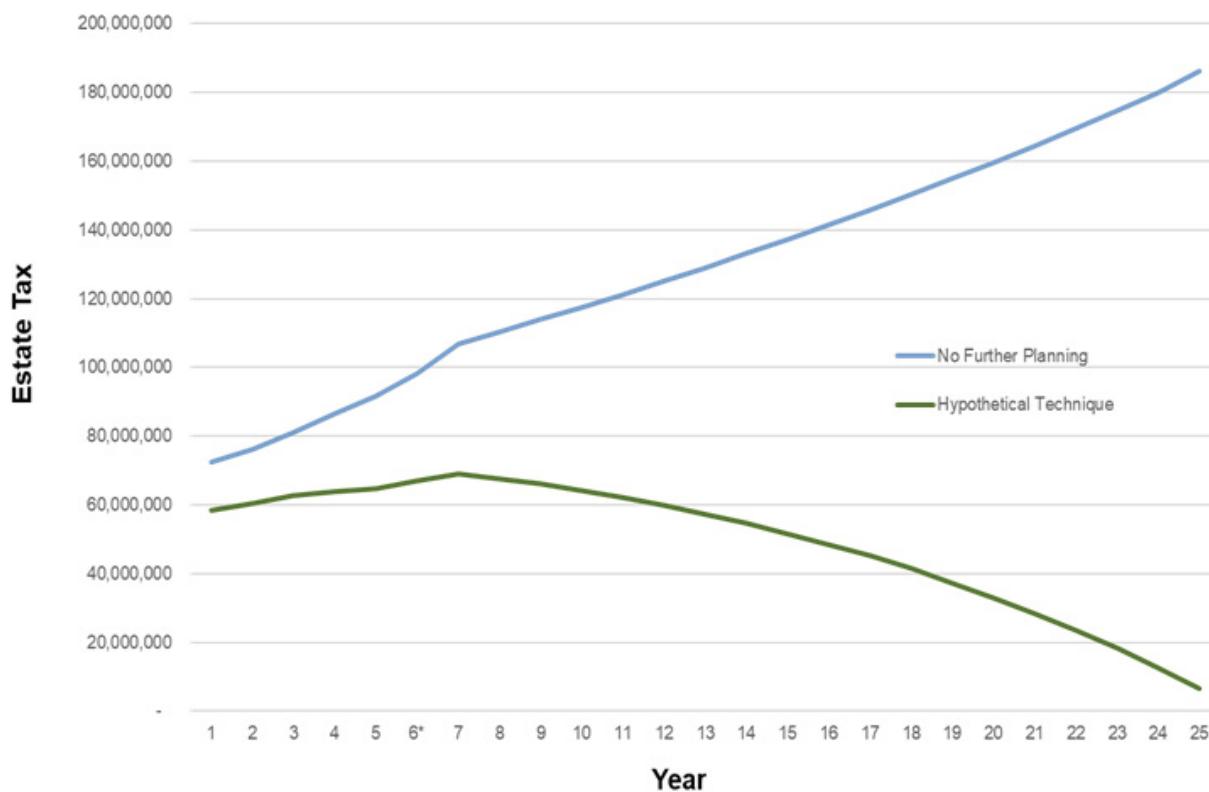
*Ann gives \$1,000,000 in financial assets to a grantor trust for the benefit of her family and also for the benefit of Aaron after 5 years (GST Grantor Trust 1) (Transaction 3 below). Aaron will not have a power of appointment over the trust Ann creates.*

The non-managing member interest in Holdco is assumed to have a 20% valuation discount. Aaron gives, pursuant to a defined allocation assignment, a 49.5% non-managing member interest in Holdco, LLC (assumed discounted value of \$5,855,900) to a grantor trust for the benefit of Ann and his family (GST Grantor Trust 2). He could allocate his remaining non-managing member interest to a 3-year grantor retained annuity trust (GRAT). Aaron could provide in the GRAT trust agreement that the remainder interest will be paid to the GST Grantor Trust 1 in return for \$1,000,00 in financial assets paid from GST Grantor Trust 1 (Transaction 4 below).

An illustration of the technique is below:



**Line Graph Showing the Advantage of the Technique,  
Under the Facts of Example 13, Over 25 Years**



\*It is assumed that the increased estate tax exemption sunsets in 2025 (year 6).

As noted *supra* Section IV.C.2.a. transfers of hard-to-value property to a GRAT have a distinct advantage over transfers to ordinary trusts. The regulations permit the taxpayer to insure against valuation risk by determining the amount of the retained annuity with reference to the value of the property transferred to the GRAT as finally determined for gift tax purposes.<sup>137</sup>

A sale of a remainder interest in a GRAT to a spousal grantor trust may be an attractive alternative for a taxpayer who is willing to forgo control over the future increase in value of the transferred hard-to-value property but would like to retain some possibility of access to those gains. The use of the GRAT should eliminate the gift and estate tax valuation risk.

<sup>137</sup> Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

**Table 10**

Summary of Hypothetical Results for \$307,000,000 of Assets (see attached appendix for detailed calculations)  
Post Death Scenarios (assuming Mr. and Mrs. Appointment have a joint life expectancy of 25 years)

| Appointment Beneficiaries                  |                                    | Consumption           |  | Lifetime IRS & State Income Tax |  | Tax Liability of Estate                           |  | Total<br>(9)    |
|--|------------------------------------|-----------------------|--|---------------------------------|--|---|--|-----------------|
| Children<br>(1)                            | Children &<br>Grandchildren<br>(2) | Direct<br>Cost<br>(3) | Investment<br>Opportunity<br>Cost<br>(4) | Direct<br>Cost<br>(5)           | Investment<br>Opportunity<br>Cost<br>(6) | Embedded<br>Capital Gains<br>Tax Liability<br>(7) | IRS<br>Estate Tax<br>(at 40.0%)<br>(8) |                 |
| <b>25-Year Future Values</b>               |                                    |                       |  |                                 |  |   |  |                 |
| No Further<br>Planning                     | \$402,476,534                      | \$121,209,327         | \$119,552,174                            | \$140,651,390                   | \$213,965,437                            | \$275,197,726                                     | \$6,733,601                            | \$186,250,244   |
|  | \$523,685,861                      |                       | \$260,203,563                            |                                 | \$489,163,163                            |   | \$192,983,845                          | \$1,466,036,433 |
| Hypothetical<br>Technique                  | \$11,540,013                       | \$649,667,823         | \$119,552,174                            | \$140,651,390                   | \$215,900,630                            | \$275,197,726                                     | \$46,822,890                           | \$6,703,787     |
|  | \$661,207,836                      |                       | \$260,203,563                            |                                 | \$491,098,357                            |   | \$53,526,677                           | \$1,466,036,433 |
| <b>Present Values (Discounted at 2.5%)</b> |                                    |                       |  |                                 |  |   |  |                 |
| No Further<br>Planning                     | \$217,092,055                      | \$65,379,171          | \$64,485,317                             | \$75,866,036                    | \$115,410,943                            | \$148,439,064                                     | \$3,632,041                            | \$100,461,629   |
|  | \$282,471,225                      |                       | \$140,351,353                            |                                 | \$263,850,007                            |   | \$104,093,670                          | \$790,766,256   |
| Hypothetical<br>Technique                  | \$6,224,574                        | \$350,424,710         | \$64,485,317                             | \$75,866,036                    | \$116,454,768                            | \$148,439,064                                     | \$25,255,826                           | \$3,615,959     |
|  | \$356,649,284                      |                       | \$140,351,353                            |                                 | \$264,893,832                            |   | \$28,871,786                           | \$790,766,256   |

2. Transfer tax advantage of the technique.

Even though the selling spouse is a beneficiary, the assets that are sold will not be included in the selling spouse's estate if the sale is for adequate and full consideration. Easy to value assets that are sold can easily be sold for adequate and full consideration.

3. Income tax advantages of the technique.

a. There will be no capital gains consequence on the original sale of the assets to the trust.

A sale to a Spousal Grantor Trust should not be recognized for income tax purposes because of IRC Sections 1041 and 671. As noted above, under Rev. Rul. 85-13, a grantor trust is deemed to have no existence with respect to transactions between the grantor and the trust. To say that transactions between the grantor and the trust are treated as transactions between the grantor and himself is not quite the same as saying that transactions between a third party and the trust are treated as transactions between the third party and the grantor. The latter conclusion, however, follows logically from the former, and this extension of Rev. Rul. 85-13 has been endorsed by two private rulings. PLR 8644012 and PLR 200120007 hold that a transfer between H (or H's grantor trust) and W's grantor trust is treated the same way as a transfer between H

and W and is governed by IRC Section 1041.<sup>138</sup> Therefore, there should be no capital gains tax consequences to the transactions explored above.<sup>139</sup>

However, interest on notes issued as consideration for a sale to a spousal grantor trust will be recognized for income tax purposes, because IRC Section 1041 does not prevent inter-spousal interest from being taxable. Generally, assuming the asset sold to the spousal grantor trust is itself an investment asset, the interest will produce an offsetting deduction and income to the spouses. The principal and income of the notes can be paid with cash flow that is naturally distributed to the partners in order to pay their income taxes.

- b. By using basis enhancing techniques the basis of the taxpayer's assets may be increased.

*See supra* Sections IV.A.3.a.(13)(c) and (14)(b).

- c. The technique has the asset class location advantage of the SIDGT technique.

*See supra* Section IV.A.3.a.(2).

B. Considerations of the Technique.

1. Federal income tax considerations.

As noted above, the sale to a Spousal Grantor Trust should be income tax free. However, the seller will be taxed on the interest on the note. As long as the seller spouse is living, he or she should receive a corresponding deduction on the interest on the note. Thus, assuming the spouses file joint returns, the interest income and the interest deduction should be a “wash” in most circumstances.

2. State income tax considerations.

*See discussion supra* Section IV.A.3.a.(6).

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<sup>138</sup> *See also* CCA 201343021 (“Accordingly, we conclude that a trust that is treated as a grantor trust is ignored as a separate entity apart from the owner for all federal income tax purposes.”).

<sup>139</sup> *Rothstein v. United States*, 735 F.2d 704 (2<sup>nd</sup> Cir. 1984), held that a transaction between a grantor trust and a grantor was not disregarded for income tax purposes. This case has not been overruled and stands as authority of a high level against the income tax analysis herein. However, the IRS disagreed with the case in Rev. Rul. 85-13 and, it appears, has never departed from Rev. Rul. 85-13 or relied on the case even when to do so would have favored the government. As a practical matter, until the IRS reverses its holding in Rev. Rul. 85-13, it seems that Rothstein may be ignored. *See also* the discussion *supra* Section IV.B.3.

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3. It is prudent to file gift tax returns.

In order to get the gift tax statute of limitations running, it is advisable to file a gift tax return even if the grantor/seller to the Spousal Grantor Trust is reasonably confident that the sale is for adequate and full consideration. If the gift tax return is accepted there should not be any gift tax consequences<sup>140</sup> and arguably there should not be any further open issue with respect to IRC Section 2036, even if the grantor/seller is a beneficiary of the trust.<sup>141</sup> However, if the Service successfully takes the position that the sale is not for adequate and full consideration, the seller will be considered a grantor of a portion of the trust. For IRC Section 2036 purposes, not only the portion of the trust in which the grantor has made a gift will be brought back into the grantor's estate, but that portion associated with the note may be brought back into the grantor's estate. There will be a consideration offset for the note allowed under IRC Section 2043, but that is generally inadequate if there has been appreciation in the assets of the trust. Thus, it is very advantageous to find out what portion of the trust the grantor/seller is considered a grantor by filing a gift tax return. As noted above, it may be possible to do further planning to ameliorate the IRC Section 2036 concerns by splitting the trust into a portion the seller is considered a grantor of and a portion in which the spouse is considered a grantor. However, it is unclear if filing gift tax returns will run the statute of limitations on all IRC Section 2036 issues. *See* the discussion *infra* Section VI.C.3.b.(4).

4. Reciprocal trust doctrine considerations.

The common law reciprocal trust doctrine could be applied by the IRS and or the courts in the creation of mutual spousal grantor trusts.<sup>142</sup> Perhaps one of the cleaner ways to lessen concerns about the application of that doctrine is if only one spouse is the seller to each trust, created by the spouses. Particularly, if the sales are done for different considerations and using different trust techniques (e.g., one sale involves the sale to a spousal grantor trust and the other transaction involves the contribution of leveraged FLLC interests to a GRAT).

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<sup>140</sup> See IRC Section 2504(c).

<sup>141</sup> See IRC Section 2001(b); Treas. Reg. Section 20.2001-1(b). See, however, the discussion *infra* Section VI.C.3.(b)(4).

<sup>142</sup> See *U.S. v. Grace*, 396 U.S. 316 (1969); *Estate of Levy*, T.C. Memo 1983-453, 46 T.C.M. (CCH) 910; PLR 9643013; and PLR 200426008.

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5. Some commentators have expressed the consideration that if it is possible for a current creditor, or any future creditor, of the assigning beneficiary to reach part of the assets of the spousal grantor trust for a period of time that does not end before the assigning spouse/beneficiary's death, by either voluntary or involuntary assignment by the assigning spouse/beneficiary, then that part of the trust may be included in the assigning spouse/beneficiary's estate under IRC Sections 2036 or 2038. See the discussion *supra* Section IV.D.3.

Even if an assigning spouse/beneficiary does not have any current creditors, or any future creditors, if the assigning beneficiary *could* create a creditor relationship under which part of the spousal trust assets, either under state law or federal bankruptcy law, would be available to satisfy the creditor obligation, that part of the trust will be included in the assigning spouse/beneficiary's estate for estate tax purposes. Even if the sale is for adequate and full consideration for gift tax purposes the IRS could take the position that either (i) the sale is not adequate for creditor protection purposes under the relevant state property law or (ii) even if the sale is adequate for state law purposes, the assigning beneficiary, under certain assumptions, could still create a future creditor relationship that could access the trust.

The sale should be for adequate and full consideration, not only for gift tax purposes, but also for state law creditor protection purposes. There is more pressure on a sale to a spousal trust in which the seller is also a beneficiary of the trust. Generally speaking, under the law of most states, an assigning beneficiary's creditor can reach the maximum amount that can be distributed by a trustee to the assigning beneficiary, if there is an assignment by the assigning beneficiary for less than full consideration under state property law.<sup>143</sup> In other words, under the laws of most states, a grantor of a trust cannot create a trust and achieve creditor protection to the extent the grantor could be a beneficiary of that trust. It is the IRS's view, which has had some success in the courts, that a retained "string" exists under IRC Section 2036 or 2038, if the settlor of the trust has the capacity of creating such a creditor.<sup>144</sup> It does not matter at the time of death that such a creditor exists – it only matters that the creditor could exist because of the assigning beneficiary's actions. As noted above, if IRC Section 2036 or 2038 apply, all of the appreciation in the trust after the sale may also be included because of the manner in which the consideration offset is applied under IRC Section 2043. Thus, it is important that the sale be for adequate and full consideration for state law creditor protection purposes, in order to avoid grantor status for the assigning beneficiary, which also affects the estate tax consequences of the transaction.

Nineteen states ("self-settled states") have adopted varying ways in which a grantor can create a self-settled trust, with an independent trustee, and also be a discretionary beneficiary of that trust, and the grantor's future creditors cannot reach the beneficial interest in the trust. What

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<sup>143</sup> E.g., *Vanderbilt Creditor Corp. v. Chase Manhattan Bank*, N.A., 473 N.Y.S. 2d 242 (App. Div. 1984); comment f to Restatement (3d) of Trusts § 60.

<sup>144</sup> Rev. Rul. 76-103, 1976-1 CB 293; Rev. Rul. 77-378, 1977-2 CB 348; *Estate of Paxton v. Commissioner*, 86 TC 785 (1986) and cases cited therein; *Outwin v. Commissioner*, 76 TC 153 (1981), acq. 1981-2 CB 1; *Paolozzi v. Commissioner*, 23 TC 182 (1954), acq. 1962-1 CB 4.

if the assigning spouse/beneficiary does not live in one of those states, and the sale is not for adequate and full consideration, but creates a trust subject to the law of one of those states that allow self-settled trusts? The IRS may take the position that even though the spousal grantor trust is subject to the self-settled state's laws, because of operation of the assigning spouse/beneficiary's state law (assuming the assigning spouse/beneficiary lives in a state that does not allow self-settled trusts), the assigning spouse/beneficiary could create a creditor relationship that would allow the creditor access to trust assets, which indirectly allows an assigning spouse/beneficiary to retain the ownership for estate tax purposes. The IRS may take the position that the assigning spouse/beneficiary of a common law state could, at any time, create a significant debt and enjoy the benefit of the proceeds of that debt. That creditor, if not paid, could get a judgment against the assigning spouse/beneficiary. The IRS could take the position that any such judgment is enforceable against both the assigning spouse/beneficiary and the part of the trust the assigning spouse/beneficiary creates, even if under the state law governing the trust that judgment would not be enforceable. The IRS may take the position that creation of the trust would be against public policy of the domicile state of the assigning spouse/beneficiary. The IRS could argue that either because of comity, full faith and credit clause under the Constitution<sup>145</sup> and/or conflict of law rules,<sup>146</sup> the trust jurisdiction state would allow that potential creditor access to the trust.<sup>147</sup> It would not matter to the IRS, for purposes of IRC Section 2036(a)(1), that the creditor never exists. The fact that the assigning spouse/beneficiary *could* create that relationship gives the assigning spouse/beneficiary a retained power to access the trust anytime and at the moment of death. There is not any definitive case law with respect to state property law creditor aspects of the above analysis nor the federal tax law aspects of the above analysis. *See infra* Section VI.C.b.(6).

The IRS may also take the position that the assigning spouse/beneficiary of a trust subject to the laws of a self-settled state *could* create a creditor relationship, even if the assigning spouse/beneficiary is domiciled in that self-settled state, if there is a sale that constitutes inadequate consideration for state law property purposes, or because of federal bankruptcy laws. If the assigning spouse/beneficiary creates a self-settled trust, within 10 years of his death, the IRS could argue that the assigning spouse/beneficiary could have filed a bankruptcy petition under Chapter 7 within 10 years of his death, and the bankruptcy trustee could avoid the transfer

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<sup>145</sup> “Full faith and credit shall be given in each state to the public acts, records and judicial proceedings of every other state.” (U.S. Const. Art IV, § 1). See also *Tennessee Coal, Iron & R.R. Co. v. George*, 233 U.S. 354, 360 (1914) and *Toni I Trust v. Wacker*, 2018 WL 1125033 (Alaska, Mar. 2, 2018). *But see, In re Cleopatra Cameron Gift Trust*, 931 N.W.2d 244 (S.D. 2019), in which the South Dakota Supreme Court rejected a California court’s order that a South Dakota trustee pay spousal support and child support owed by a trust beneficiary. The court reasoned that full faith and credit does not require a forum state to adopt the enforcement mechanisms of another jurisdiction.

<sup>146</sup> See comment d to § 145 of the Second Restatement of the Conflict of Laws, which states:

[S]ubject only to rare exceptions, the local law of the state where conduct and injury occurred will be applied to determine whether the actor satisfied minimum standards of acceptable conduct and whether the interest affected by the actor’s conduct was entitled to legal protection.

<sup>147</sup> *In re Huber*, 2013 Bankr. LEXIS 2038 (May 13, 2013); *Toni I Trust v Wacker*, 2018 WL 1125033 (Alaska, Mar. 2, 2018).

to the self-settled trust and bring the trust assets back into the bankruptcy estate for the benefit of creditors, because of 11 U.S.C. § 548(e). *See* the bankruptcy court decision in the *Battley v. Mortensen*, No. A09-90036-DMD (D. Alaska 5/26/11) holding that creditors of an Alaskan resident, whose claims arose after a validly created Alaskan self-settled trust, within 10 years of the transfer to the trust, could be satisfied in bankruptcy from the self-settled trust. On the other hand, 11 U.S.C. § 548(e) does not confer upon creditors the right to enforce satisfaction of a debt against a self-settled trust except in a bankruptcy proceeding, and it does not apply to a transfers more than 10 years prior to the bankruptcy. Thus, creditors' rights under federal bankruptcy law are significantly less than under the state law that exists outside the 17 states permitting self-settled trusts, and may not have the same effect for federal transfer tax purposes, especially where the transferor remains solvent at all times prior to death, with bankruptcy not more than a remote possibility. The application of 11 U.S.C. § 548(e) requires proof of an actual intent by the transferor to hinder potential future creditors, which may be absent when the transfer has significant other purposes.

However, most commentators believe the IRS will not make the bankruptcy-based argument, or the extreme version of the fraudulent transfer argument, discussed above. If the mere *possibility* of voiding a transfer to a spousal grantor trust on fraudulent transfer grounds made a trust a non-grantor trust, this would automatically make *every* inter vivos trust a non-grantor trust until the statute of limitations ran out, and even this would be hard to discern, since it may be ten years or longer depending on the court and circumstances. The IRS would more likely adopt a more reasoned approach to avoid such absurdity, such as that espoused in qualified disclaimer regulations,<sup>148</sup> which state that the mere possibility of a disclaimer being voided under fraudulent transfer law does not disqualify it, but the *actual* voiding of the transfer would. This would also be a logical way to analyze the potential effect of such claims for spousal grantor/non-grantor trust purposes as well – if a settlor's creditors succeed in piercing an irrevocable trust on fraudulent transfer grounds it certainly causes grantor trust status, but not until then.

6. If a current or future creditor of an assigning beneficiary does reach part of the assets of a self-settled trust, then that part of the trust may not constitute a completed gift for gift tax purposes.

The IRS could argue that because of state property law, or federal bankruptcy law, the grantor/beneficiary could create a future creditor relationship, which would terminate part or all of the trust. That power by the assigning beneficiary would mean that the assigning beneficiary has retained dominion and control over that part of the trust, and has not completed a gift for gift tax purposes under Treas. Reg. § 25.2511-2(b).<sup>149</sup> However, see the analysis *supra* Section V.B.5. Under that analysis, if the IRS made that completed gift argument, that may make every

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<sup>148</sup> Treas. Reg. § 25.2518-1(c).

<sup>149</sup> *See Outwin v. Commissioner*, 76 TC 153 (1981), acq. 1981-2 CB 1; *Herzog v. Commissioner*, 116 F2d 591 (2d Cir. 1941).

trust an incomplete gift. Most practitioners believe the IRS will probably take a more reasoned approach.

## VI. SOME OF THE BEST CREATIVE TAX PLANNING TECHNIQUES FOR BENEFICIARY GRANTOR TRUSTS THAT ARE CREATED BY A THIRD PARTY THAT IS NOT THE BENEFICIARY'S SPOUSE.

Some trusts, sometimes referred to as “beneficiary-owned” trusts or, historically, as *Mallinkrodt* trusts, are treated under IRC Section 678(a) as owned, in whole or in part, by a person other than the grantor.<sup>150</sup> The use of beneficiary-owned trusts is perhaps becoming increasingly common, even as certain of the techniques remain controversial. This section addresses some of the ways in which IRC Section 678 can be used.<sup>151</sup>

Although IRC Section 678 refers to a “person other than the grantor” being considered the income tax owner of a portion of a trust, the person is commonly referred to, including in this outline, as a “beneficiary” of the trust.

### A. IRC Section 678 Overview.

#### 1. Three paths to beneficiary ownership.

IRC Section 678 defines three separate ways in which a person other than the grantor can be considered the owner of a portion or all of trust property.

##### a. IRC Section 678(a)(1) ownership because of power to vest corpus or income of the subject trust.

First, under IRC Section 678(a)(1), a person other than the grantor is treated as the owner of any portion of a trust with respect to which that person has a power, “exercisable solely by himself,” to vest the corpus or the income of such portion in himself, herself, or itself.<sup>152</sup> Although the IRS does not appear to have embraced the term, in recent years, trusts treated as owned by a person other than the grantor under IRC Section 678(a)(1) have been referred to as “beneficiary defective owned trusts” or “BDOTs.”<sup>153</sup>

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<sup>150</sup> In *Mallinkrodt v. Nunan*, 146 F.2d 1 (8<sup>th</sup> Cir. 1945) – which was decided before subchapter J was enacted – the beneficiary was treated as the owner for income tax purposes of undistributed income that the beneficiary had the power to withdraw.

<sup>151</sup> For an excellent overview of IRC Section 678, see Blattmachr, Gans, and Lo, “A Beneficiary as Trust Owner: Decoding Section 678,” 35 ACTEC L. J. 106 (2009).

<sup>152</sup> Treas. Reg. § 1.678(a)-1 (first sentence). For an example of IRC Section 678(a)(1) trust or BDOT, see PLR 201633021. *See also* Rev. Rul. 67-241; Rev. Rul. 81-6.

<sup>153</sup> For an in-depth discussion of the BDOT technique, see Ed Morrow “IRC § 678(a)(1) and the ‘Beneficiary Deemed Owner Trust (BDOT)’ (Leimberg Information Services, Inc., September 5, 2017), updated at SSRN: <https://ssrn.com/abstract=3165592>. It could be noted that this paper differs in certain respects from Mr. Morrow’s paper as to how the withdrawal right could be designed. For instance, there may be certain IRC Section

- b.     IRC Section 678(a)(2) ownership because of partial release or other modification of vesting power, plus other grantor trust strings.

Second, under IRC Section 678(a)(2), a person other than the grantor is treated as the owner of any portion of a trust with respect to which that person has “previously partially released or otherwise modified” an IRC Section 678(a)(1) vesting power and retains an interest in or control over the trust that would cause the grantor to be treated as the trust owner under IRC Sections 671 through 677.<sup>154</sup> IRC Section 678(a)(2) trusts are frequently referred to as “beneficiary defective inheritor’s trusts” or “BDITs,” in contrast to their BDOT cousins.

- (1)     IRS treats lapse as a release.

IRC Section 678(a)(2), in contrast to its estate and gift tax analogs,<sup>155</sup> requires a “release” of a vesting power. Nevertheless, in non-precedential private letter rulings,<sup>156</sup> the IRS has consistently viewed a lapse as equivalent to a release.<sup>157</sup>

- (2)     IRS treats complete lapse as a “partial release” or modification.

IRC Section 678(a)(2) only triggers beneficiary ownership following a partial release or modification of an IRC Section 678(a)(1) vesting power. Nevertheless, in non-precedential private letter rulings,<sup>158</sup> the IRS has also consistently viewed a complete lapse as equivalent to a partial release.<sup>159</sup> In one ruling obtained in 2009, the lapse was indeed merely partial.<sup>160</sup> Some contend that, without a ruling, taxpayers should not assume that a complete lapse can cause IRC Section 678(a)(2) to apply.

- (3)     Continuing grantor trust string required.

In order for IRC Section 678(a)(2) to apply, not only must an IRC Section 678(a)(1) vesting power have been partially released or otherwise modified, but the beneficiary must

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678 concerns for a tax year if the beneficiary does not have the unfettered right to withdraw net taxable income for the full year. *See also* IRC Sections 678 and 671 and Treas. Reg. §§ 1.678(a)-1, 1.671-2 and 1.671-3.

<sup>154</sup> Treas. Reg. § 1.678(a)-1 (second sentence). For an example of IRC Section 678(a)(2) trust or BDIT, see PLR 200949012.

<sup>155</sup> *See* IRC Sections 2041(b)(2), 2514(e).

<sup>156</sup> Under IRC Section 6110(k)(3), a written determination may not be used or cited as precedent.

<sup>157</sup> *See, e.g.*, PLRs 200949012, 200747002, 9809005, 8342088.

<sup>158</sup> Under IRC Section 6110(k)(3), a written determination may not be used or cited as precedent.

<sup>159</sup> *See, e.g.*, PLRs 200747002, 200104005, 20014744, 20022035, 9809005, 9450014, 9448018, 9808033, 8342088.

<sup>160</sup> PLR 200949012.

thereafter have retained a grantor trust “string” that, if the beneficiary were the grantor of the trust, could cause him, her, or it to be treated as the owner under the rules of IRC Section 671-677 and IRC Section 679.

c. Deemed IRC Section 678(a) ownership via a QSST.

The beneficiary of a qualified subchapter S trust, as defined in IRC Section 1361(d)(3), may make an election to be treated as the owner under IRC Section 678(a) of the portion of the trust which consists of stock in an S corporation.<sup>161</sup>

2. Grantor’s ownership trumps beneficiary ownership.

IRC Section 678(b) provides that IRC Section 678(a) does not apply “with respect to a power over income” if the grantor is otherwise treated as the owner of under IRC Sections 671-677 and IRC Section 679. Although IRC Section 678(b) refers to a power over “income,” the IRS has consistently viewed a grantor trust string with respect to corpus as overriding beneficiary ownership under IRC Section 678(a).<sup>162</sup> To achieve IRC Section 678(a) beneficiary ownership, therefore, it is essential, if the grantor is still living, to negate all possible grantor trust strings with respect to the grantor.

3. Sales to BDITs and BDOTs a no rule area.

Perhaps reflecting IRS concerns with aggressive IRC Section 678(a) leveraged sale planning, the IRS will not ordinarily rule on IRC Section 678 status “if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.”<sup>163</sup>

B. Sales to LLCs Owned by BDOTs.

This section analyzes the technique of a transferor selling assets for a note to a limited liability company that is owned by a third party created trust that is a BDOT in which the selling transferor, as the beneficiary of the BDOT, has the power to withdraw in any calendar year of the trust, all of the net taxable income of the trust earned by all of the trust assets, and that withdrawal power can be satisfied out of the entire accounting income and/or corpus and/or proceeds of the corpus of the trust (sometimes referred to below as the “Income Withdrawal Right Beneficiary”).

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<sup>161</sup> IRC Section 1361(d)(1)(B).

<sup>162</sup> PLRs 200949012, 200729005, 2007320101, 200603040, 9309023; *cf.* Rev. Rul. 81-6; *see also* Treas. Reg. § 1.671-2(b) (distinguishing, for purposes of the grantor trust regulations, between “income,” which means income for tax purposes, and “ordinary income,” which means income under fiduciary accounting principles).

<sup>163</sup> Rev. Proc. 2020-3.

1. Overview of technique.

A third party could create an inter vivos or testamentary estate tax protected trust, of any value, in which the beneficiary is the deemed income tax owner. This technique allows significant initial funding, which is different than the beneficiary defective inheritor's trust technique ("BDIT"), which generally is only funded with \$5,000 of assets when it is created. Under IRC Section 678(a)(1), if a beneficiary of a third party created trust has the unilateral power to "vest income" of the trust in himself, then the trust is disregarded for income tax purposes and the net taxable<sup>164</sup> income of the trust is taxable to the beneficiary. In order to vest income of the trust, the beneficiary of the trust should have the unilateral power to withdraw all of the net taxable income of the trust to himself, with all of the assets of the trust being available to satisfy that withdrawal power, including the trust's accounting income, the trust's corpus and the trust's proceeds from sales of the trust corpus.<sup>165</sup>

2. Application of IRC Section 678(a)(1).

IRC Section 678(a)(1) provides as follows:

"(a) General rule A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

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

The reference to "income" in Section 678(a)(1) is taxable income and not accounting income. If a beneficiary of a BDOT has the right to withdraw net taxable income, the beneficiary has the right to withdraw not only dividends and interest, but income normally allocated to principal such as capital gains income.

Assume a grantor of a trust sells assets to a trust which gives the grantor the right to withdraw all realized income of the trust from whatever the source, including all accounting income and realized capital gains income of that trust. That withdrawal right could be satisfied from any asset or cash source of the trust, including accounting income, sale proceeds of the corpus and the corpus. That sale would be disregarded for income tax purposes under the authority of IRC Sections 671 and 677, Treasury Regulation Sections 1.671-2,1-671-3, 1.677(b)(2), 1.677(c)(2), and 1.677(g), example 2, and Rev. Rul. 85-13. Likewise, a sale by a

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<sup>164</sup> While the term "net taxable income" is not a defined term under trust property law the elements of net taxable income can be determined under trust property law.

<sup>165</sup> Such a withdrawal power should distinguish the holding of the court in *Fish v. U.S.*, 432 F.2d 1278 (9th Cir. 1970) and the IRS in Revenue Ruling 85-88, 1982-2 C.B. 201 that the 5% lapsed protection from transfer taxes provided by IRC Sections 2514(e) and 2041(b)(2) is only measured by 5% of the accounting income of the trust when the withdrawal right only applies to accounting income. If the measure is all of the net taxable income, and that withdrawal power can be satisfied out of the entire accounting income, and/or corpus, and/or proceeds of the corpus of the trust, the 5% lapsed protection is increased to be measured by 5% of the trust corpus under IRC Sections 2514(e) and 2041(b)(2). See Treas. Reg. § 25.2514-3(c)(4).

beneficiary of a trust to a trust in which the beneficiary has the same withdrawal right that the grantor has in the above example, should be disregarded under the authorities noted in this section, because the beneficiary is treated as owning the consideration for income tax purposes both before and after the transaction.

*Example 14: A Parent Creates a \$2,000,000 BDOT for the Benefit of Her Daughter; Daughter Sells Significant Assets in Two Different Cascading Sales for Notes to a Limited Liability Company Owned by the BDOT*

*In 2016, Betsy Bossdaughter created a single member LLC with a 0.01% Class A managing member interest, a 0.99% Class B managing member interest and a 99% non-managing member interest and the LLC held \$57,000,000 in assets (Transaction 1 below). In 2017 Granny Selfmade transfers \$2,000,000 in assets to a BDOT that is also a GST exempt trust (Transaction 2 below). (Note: Granny could create the trust by her will, or during her lifetime, if Granny retains no interest or power that would cause her to be taxed on the trust income under the grantor trust rules.) The terms of the BDOT provide Granny's daughter, Betsy Bossdaughter, the power to withdraw in any calendar year of the BDOT all of the net taxable income of the BDOT. The terms of the BDOT provide that withdrawal power can be satisfied out of the entire income, corpus, or proceeds of the corpus of the trust. If Betsy does not exercise her withdrawal power in any calendar year it will lapse. Betsy is also given a special testamentary power of appointment in the BDOT trust documents. The remainder beneficiaries of the BDOT after her death, subject to the power of appointment, are Betsy's children and grandchildren.*

*In 2018, the BDOT contributes its \$2,000,000 to Granny Family LLC. Later, in 2018, Betsy sells a 49.5% non-managing member interest in Bossdaughter Family LLC to Granny Family LLC, which is owned by the BDOT, in exchange for \$19,750,500 note (Transaction 3 below). Due to IRC Section 2036 considerations with respect to retaining entity distribution, amendment and liquidation powers, Betsy could retain the 0.01% Class A managing member interest and transfer the 0.99% Class B managing member interest. The Class A managing member interests would control all entity managing member decisions, including investment management decisions that are not delegated to the Class B managing member interest. The Class B managing member interests would control all distribution, amendment and liquidation decisions. Betsy could give her Class B managing member interest to a grantor trust in which the initial trustee is an advisor or family member she trusts. Betsy could have the power to replace the trustee of that donee trust with a new trustee, as long as the replacement trustee is not related or subservient.*

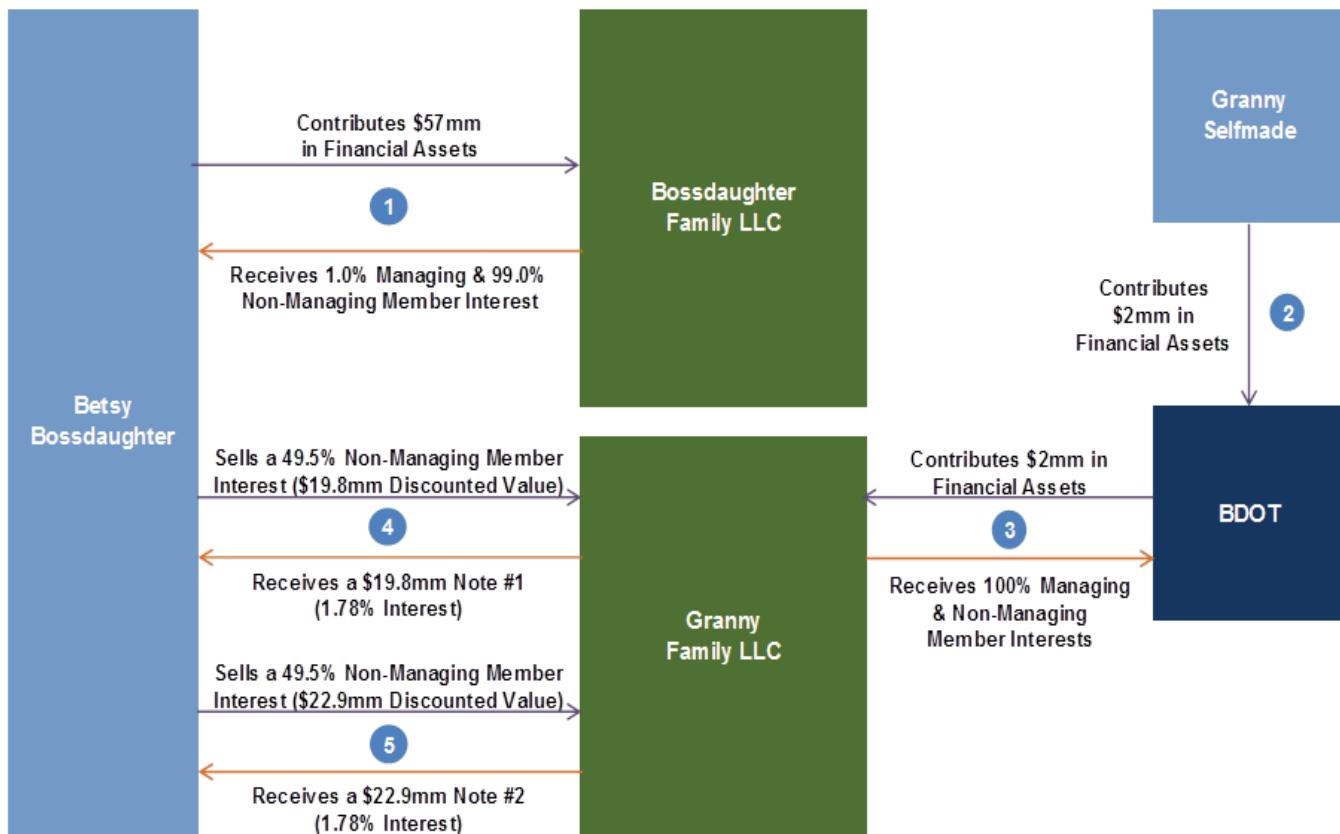
*It is assumed there is a 30% valuation discount associated with the sold 49.5% non-managing member interest. The assets in the LLC and the \$2,000,000 in the BDOT outside of its ownership of the LLC annually grow at 6% per year pre-tax. In 2021, Betsy sells her remaining 49.5% non-managing member interest in her LLC in exchange for a \$22,896,243 note (Transaction 4 below).*

*Betsy needs \$1,000,000 a year (inflation adjusted) for her consumption needs and also needs enough additional cash flow from the BDOT and her LLC to pay her income taxes. Betsy*

plans to first look to payments on the note receivable from *Granny Family LLC*, which is owned by the *BDOT*, for those consumption and tax payment needs.

Betsy asks her tax advisor, *Mable Mathgeek*, how many years will it take the *BDOT* to pay off her note receivables under those above assumptions and what will be the undiscounted value of the assets of *Granny Family LLC* that is owned by the *BDOT* when the notes are paid off?

The technique is illustrated below:



Under the above assumptions, the *BDOT* will have paid all of its note receivables in 27 years. At that point, the undiscounted value of the *BDOT* assets will be worth \$126,613,473. After the notes are totally paid, going forward, Betsy could use her withdrawal power over the *BDOT* to satisfy her consumption and tax payment needs. The assets of the *BDOT*, if the trust document is properly drafted and the trust is properly administered, will not be subject to Betsy's estate tax. Furthermore, Betsy may use her transfer tax exemptions to engage in additional estate planning. See the table below and attached Schedule 10 for a summary of those calculations based on the above assumptions and assuming Betsy dies in 30 years.

Table 11

| Bossdaughter Beneficiaries                 |                          | Consumption   |                             | IRS Income Tax |                             | Tax Liability of Estate    |                        | Total         |
|--|--------------------------|---------------|-----------------------------|----------------|-----------------------------|----------------------------|------------------------|---------------|
| Children                                   | Children & Grandchildren | Direct Cost   | Investment Opportunity Cost | Direct Cost    | Investment Opportunity Cost | Embedded Capital Gains Tax | IRS Estate Tax (@ 40%) |               |
| <b>30-Year Future Values</b>               |                          |               |                             |                |                             |                            |                        |               |
| No Further Planning                        | \$84,778,260             | \$34,657,505  | \$43,902,703                | \$60,266,542   | \$26,310,348                | \$32,272,303               | \$159,477              | \$56,518,840  |
|  | \$119,435,766            |               | \$104,169,246               |                | \$58,582,651                |                            | \$56,678,317           | \$338,865,979 |
| Hypothetical Technique - BDOT              | \$0                      | \$172,950,276 | \$43,902,703                | \$60,266,542   | \$27,346,891                | \$32,272,303               | \$2,127,264            | \$0           |
|  | \$172,950,276            |               | \$104,169,246               |                | \$59,619,194                |                            | \$2,127,264            | \$338,865,979 |
| <b>Present Values (discounted at 2.5%)</b> |                          |               |                             |                |                             |                            |                        |               |
| No Further Planning                        | \$40,417,415             | \$16,522,712  | \$20,930,293                | \$28,731,633   | \$12,543,266                | \$15,385,584               | \$76,029               | \$26,944,944  |
|  | \$56,940,128             |               | \$49,661,926                |                | \$27,928,850                |                            | \$27,020,973           | \$161,551,877 |
| Hypothetical Technique - BDOT              | \$0                      | \$82,452,779  | \$20,930,293                | \$28,731,633   | \$13,037,430                | \$15,385,584               | \$1,014,157            | \$0           |
|  | \$82,452,779             |               | \$49,661,926                |                | \$28,423,015                |                            | \$1,014,157            | \$161,551,877 |

### 3. Income tax advantages of the technique.

- a. The technique has all of the income tax advantages of the SIDGT technique or the LAIDGT technique.

The BDOT is treated as a grantor trust to the beneficiary based on IRC Section 678, which is basically a codification of the *Mallinckrodt* case.<sup>166</sup> Thus, a sale by the beneficiary of the BDOT to the BDOT, under the regulations under IRC Sections 671-677, 678 and 1001, would appear to have the same advantages as the SIDGT technique or the LAIDGT technique.

Revenue Ruling 85-13, 1985-1 C.B. 184, citing the authority of *Dobson v. Commissioner*, 1 B.T.A. 1082 (1925) and other authorities concluded that “a transaction cannot be recognized as a sale for income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction.” (Emphasis added.) Under the facts of that ruling the grantor has control over, and the use of, the entire corpus. The ruling considers whether transactions a grantor has with a grantor trust are disregarded for income tax purposes. The ruling holds that transactions and other activities by the grantor of the trust, with respect to a grantor trust, will be disregarded. The ruling also cited several authorities, which hold that when the grantor of a grantor trust is treated as the income tax owner of the trust for income tax purposes, the grantor is also considered the owner of the trust assets for income tax purposes.

The analysis of Rev. Rul. 85-13 with respect to the tax nature of a grantor’s transactions with a grantor trust is contrary to the Second Circuit’s analysis in *Rothstein v. United States*, 735 F.2d 704 (2nd Cir. 1984). In that case, the Second Circuit held that while a grantor of a grantor trust is treated as the owner of a grantor trust’s assets for purposes of determining income,

<sup>166</sup> *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir. 1945).

deductions, and credits attributable to the trust, the grantor trust is not disregarded for income tax purposes with respect to any transactions or activities the trust may have with the grantor. The IRS in Rev. Rul. 85-13 announced it would not follow the analysis in *Rothstein*.

- b. What does it mean for a “portion” to be treated as owned under IRC Section 678?

In the context of the holding of Rev. Rul. 85-13 what does the term “portion” mean when that term is used in IRC Section 678? Does it mean, under IRC Section 678(a)(1), “income” portion as opposed to “corpus” portion? Or does it mean, under IRC Section 678(a)(1), that undivided interest of the trust in which a person could vest in himself either that undivided interest’s corpus or net taxable income (*i.e.*, ordinary income and capital gains income)?

Perhaps the beginning point of the analysis of what is the meaning of the term “portion” under IRC Section 678(a)(1), is Treas. Reg. § 1.678(a)-1(a). The key part of the first sentence of that regulation provides “where a person other than the grantor of a trust has a power exercisable solely by himself to vest ... the income of any portion of a ... trust in himself, he is treated under section 678 (a) as the owner of that portion ....” (Emphasis added.”)

The last sentence of Treas. Reg. § 1.678(a)-1(a) incorporates, for purposes of IRC Section 678(a)(1), the grantor trust rules, which describe generally how the income tax rules work under IRC Section 671(a)(1) for any deemed income tax owner of any portion of a trust under IRC Section 671, Treas. Reg. §§ 1.671-2 and 1.671-3. These rules apply also in determining the treatment for any deemed income tax owner of any portion of an IRC Section 678(a)(1) trust: “See [IRC] 671 and [Treas. Reg.] §§ 1.671-2 and 1.671-3 for rules for treatment of items of income, deductions and credit where a person is treated as the owner of all or only a portion of a trust.”

*See also* the authorities under Footnote 35 where it notes that Treas. Reg. § 1.1001-2(c) Example 5 established by regulation the position in Rev. Rul. 77-402 that the grantor of a grantor trust is “the owner of all property for federal income tax purposes.” Presumably, that is true even if the grantor of the grantor trust only has powers or rights over the ordinary income and capital gains income of the trust and does not have powers or rights over the corpus of the trust. See IRC Sections 677(a)(1) and (a)(2).

Similar to IRC Sections 677(a)(1) and (a)(2), under IRC Section 678(a)(1), an Income Withdrawal Right Beneficiary may only have the right to vest taxable income (*i.e.*, ordinary income and capital gains income), and not corpus, in himself, but that is enough for the Income Withdrawal Right Beneficiary to be the deemed owner for income tax purposes of all of the trust property. While there may be transfer tax differences between a corpus withdrawal beneficiary and an Income Withdrawal Right Beneficiary of a BDOT, there do not appear to be any income tax differences.

If IRC Section 671, Treas. Reg. §§ 1.671-2 and 1.671-3 are incorporated in analyzing the operation of IRC Section 678, then the rationale of Rev. Rul. 85-13 for not recognizing a taxable sale by the deemed owner would also seem to apply. Since an Income Withdrawal Right

Beneficiary has the power to withdraw the taxable income from all trust assets and the power to satisfy that withdrawal right from either the accounting income, sale proceeds of the corpus, or the corpus of all portions of the trust, that Income Withdrawal Right Beneficiary should be the deemed income tax owner of all of the assets of the subject trust, including any consideration that is sold to the trust.<sup>167</sup> It does not matter under Rev. Rul. 85-13 whether IRC Section 671 applies because of a grantor retains rights and powers over corpus, corpus and income, or ordinary income and capital gains income only (*see* IRC Section 677). Similar to the application of IRC Section 677 under Rev. Rul. 85-13, IRC Section 678(a)(1) would appear to apply to an Income Withdrawal Right Beneficiary who only has powers and rights over ordinary income and capital gains income.

Certain of the key provisions of Treas. Reg. §§ 1.671-2 and 1.671-3, which are applied to IRC Section 678(a)(1) by the regulations under IRC Section 678(a)(1), are as follows:

“§ 1.671-2 Applicable principles.

(a) Under IRC Section 671 a grantor or another person includes in computing his taxable income and credits those items of income, deduction, and credit against tax which are attributable to or included in any portion of a trust of which he is treated as the owner. IRC Sections 673 through 678 set forth the rules for determining when the grantor or another person is treated as the owner of any portion of a trust. The rules for determining the items of income, deduction, and credit against tax that are attributable to or included in a portion of the trust are set forth in §1.671-3.

(b) Since the principle underlying subpart E (IRC Section 671 and following), part I, subchapter J, chapter 1 of the Code, is in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed, it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes. . .” (Emphasis added.)

“§ 1.671-3 Attribution or inclusion of income, deductions, and credits against tax.

(a) When a grantor or another person is treated under subpart E (section 671 and following) as the owner of any portion of a trust, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion.” (Emphasis added.)

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<sup>167</sup> Indirect support for this conclusion can also be found in *Bennett v. Comm'r*, 79 TC 470 (1982), which held that a grantor was treated as the owner of a larger portion of the trust than the portion that the grantor had actually borrowed. By the same reasoning, the deemed ownership of an Income Withdrawal Right Beneficiary should be greater than the amounts that he or she may actually withdraw. Further support can be drawn from PLR 201633021, in which a power to withdraw “any dividends, interest, fees” and other amounts of fiduciary accounting income created deemed ownership over all income of a trust, including capital gains income.

Under Section 671, Treas. Reg. §§ 1.671-2 and 1.671-3 there does not appear to be any difference in the key characteristics of how a grantor of a grantor trust is treated and an Income Withdrawal Right Beneficiary of a BDOT is treated, if the withdrawal right is of ordinary income and capital gains income generated by all trust assets and if all portions of the trust can be used to satisfy the withdrawal right. As a consequence, the Income Withdrawal Right Beneficiary of the BDOT under Example 14 should be considered, for income tax purposes, as the owner of the low basis asset both before and after the sale. Under the reasoning of Rev. Rul. 85-13 the sale should be disregarded for income tax purposes.

- c. Sales to a Single-Member LLC owned by grantor trusts or BDOTs as alternative technique if Rev. Rul. 85-13 is revoked by the IRS or deemed not to apply to BDOTs.

Rev. Rul. 85-13 is an IRS analysis of a grantor deemed owner trust and whether activities and transactions by a grantor are disregarded. What if the IRS argued that it is not bound by Rev. Rul. 85-13 with respect to an Income Withdrawal Right Beneficiary of a BDOT and it will follow the analysis in *Rothstein*?

If the taxpayer is worried about that potential IRS argument, the taxpayer should consider selling to a single member LLC that is created by a BDOT in which the taxpayer is considered the deemed income tax owner. It appears the writer of the regulations in 1996, dealing with single member LLCs, clearly rejected the *Rothstein* court's analysis, which was decided 12 years earlier, with respect to activities and transactions with single member LLCs. *See* Treas. Reg. § 301.7701-3(a); Treas. Reg. § 301.7701-3(b)(1)(ii) and Treas. Reg. § 301.7701-2(a). The "disregarded" income tax protection of a single member LLC is broader than the grantor trust income tax protection. The regulations make clear not only that the income, deductions and credits of the single member LLC are treated as if the income tax owner of the LLC owns the assets of the LLC, but in addition that all activities and transactions that the LLC has with the LLC owner are treated for income tax purposes as if those transactions were transactions a sole proprietor would have with himself. In particular, Treas. Reg. § 301.7701-2 provides:

"Its activities are treated in the same manner a sole proprietorship . . . of the owner.  
(Emphasis added.)

In other words, the *Rothstein* court's reasoning as to why "activities" should not be disregarded with respect to grantor trusts should not apply to activities with respect to single member LLCs.

Assuming the Income Withdrawal Right Beneficiary of a BDOT is considered the income tax owner of any single member LLC formed by the BDOT (see the above analysis), then the above single member LLC income tax regulations would appear to be authority for the proposition that any sale or similar activity by the Income Withdrawal Right Beneficiary of a low basis asset to a single member LLC owned by a BDOT should also be disregarded.

This analysis seems compelling at a technical level, but it has yet to be approved by the IRS or a court. It remains possible that the IRS or a court would take a policy-oriented "big

picture” approach and ask why, if a sale by the Income Withdrawal Right Beneficiary to the BDOT would not be disregarded, putting a disregarded entity between the Beneficiary and the BDOT should alter the result.

Summary of conclusions.

- Case law, regulatory and revenue ruling authorities provide that if a taxpayer sells an asset, and if that taxpayer is deemed to be the income tax owner of that asset both before and after the sale, that sale is disregarded for income tax purposes.
- Since IRC Section 671, Treas. Reg. §§ 1.671-2 and 1.671-3 apply to an IRC Section 678(a)(1) trust, the Income Withdrawal Right Beneficiary of the IRC Section 678(a)(1) trust should be treated the same as a grantor of a grantor trust. There do not appear to be any income tax differences between a corpus withdrawal beneficiary and an Income Withdrawal Right Beneficiary of the IRC Section 678(a)(1) trust.
- There is no specific regulatory authority under either IRC Section 671, Treas. Reg. §§ 1.671-2 or 1.671-3 that activities and transactions that either a grantor of a grantor trust has with that grantor trust, or an Income Withdrawal Right Beneficiary has with an IRC Section 678(a)(1) trust, are to be disregarded for income tax purposes. There is case law authority that those activities should not be disregarded. *See Rothstein v. United States*, 735 F.2d 704 (2nd Cir 1984).
- There is authority under Rev. Rul. 85-13, 1985-1 CB 184 that activities and transactions that a grantor has with a grantor trust are disregarded because the taxpayer owns the asset before and after the transaction. The analysis inherent in that revenue ruling should indicate that activities and transactions that an Income Withdrawal Right Beneficiary has with an IRC Section 678(a)(1) trust should also be disregarded. PLR 202022002 (May 29, 2020) arguably supports that analysis.
- There is specific regulatory authority that activities and transactions that a deemed income tax owner of a single member LLC has with that LLC are disregarded for income tax purposes. That regulatory authority is broader than the regulatory authority that exists for activities and transactions a grantor has with a grantor trust. That regulatory authority is also broader than the regulatory authority that exists for activities and transactions an Income Withdrawal Right Beneficiary has with an IRC Section 678(a)(1) trust.
  - d. Failing to take the withdrawing income is not relevant to the IRC Section 678 analysis.

Such a power has even been ruled effective when held by a minor even where there was no court-appointed guardian with authority to exercise the power.<sup>168</sup>

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<sup>168</sup> *Trust No. 3 v. Comm'r*, 285 F.2d 102 (7th Cir., 1960).

- e. The BDOT can be designed to be very flexible for any calendar year by giving an independent trustee, or a protector, the power to change the withdrawal power for a future year or years.
- f. The BDOT has many income tax advantages that a complex trust does not have.
  - (1) The taxable income is taxed at the beneficiary's marginal income tax rate, which is frequently lower than the trust's marginal federal income tax rate.
  - (2) The taxable income is taxed at the beneficiary's marginal state income tax rate, which is frequently lower than the trust's marginal state income tax rate.

The beneficiary may move to a state with low or no state income taxes and the concerns with a high-income tax state's "resident trust" requirement would be eliminated.

- (3) The beneficiary of a BDOT can take an IRC Section 179 expense deduction while a complex trust's ability to take that deduction is limited.<sup>169</sup>
- (4) Depending upon the BDOT beneficiary's tax bracket, and/or how active the beneficiary is in a closely held business, the 3.8% net investment income tax may not apply while under the same circumstances it may apply to a complex trust.
- (5) The BDOT can be a shareholder of an S corporation without some of the considerations of an ESBT or a QSST.

The beneficiary of a BDOT may be entitled to certain deductions that are eliminated by ESBTs. A QSST has to pay the trust accounting income of the QSST to the beneficiary, while a BDOT does not pay any income to the beneficiary unless the withdrawal right is exercised.

- g. Capital losses can be passed through to the beneficiary of the BDOT.

Assets that have a capital loss could be distributed in kind.

- h. The capital gains benefit of a residence that is inherent under IRC Section 121 will be available to sales of residences owned by a BDOT.

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<sup>169</sup> IRC Section 179(d)(4).

- i. There are increased opportunities for charitable planning because the inherent limitations under IRC Section 642(c) will be eliminated.

The beneficiary can withdraw assets that accrued from sources other than gross income in satisfaction of its withdrawal rights, and those assets can then be contributed by the beneficiary to charities.

- j. A BDOT should avoid overlapping state fiduciary income taxation.

The beneficiary-owner, however, could be subject to overlapping state individual income taxation.

4. Transfer tax advantage of the technique.

- a. The beneficiary has the opportunity by her actions to increase the value of the BDOT and, thus, the amount that is not subject to estate taxes.

To the extent the beneficiary of a BDOT does not withdraw net taxable income of the BDOT up to the lapse protection (the so-called “5 and 5” protection of IRC Section 2514(e)(2) and IRC Section 2041(b)(2)), that amount remains in the trust in a manner that will not be subject to gift taxes and estate taxes. Almost all states have legislation that protects the protected lapse portion described in IRC Sections 2514(e)(2) and 2041(b)(2) from creditors.<sup>170</sup> However, to the extent that a current or hanging power exists at death or a prior power lapsed in excess of the lapse protection, property could be accessible by creditors of the beneficiary and that portion of the BDOT will be subject to the beneficiary’s estate taxes. The beneficiary may maximize the lapse protection by always withdrawing that amount of net taxable income (payable out of income, corpus or proceeds of the corpus of the trust) that exceeds 5% of the value of the corpus of the trust. It should be noted that under this Example 14, the right to withdraw could be designed to only occur if the trust and/or protector has not removed that withdrawal right in a prior year.

- b. Because the beneficiary is the deemed income tax owner of the BDOT, there is flexibility to allow the beneficiary to sell life insurance policies to the BDOT.
- c. A sale by an income right withdrawal beneficiary to a BDOT Has all of the transfer tax advantages of a LAIDGT.

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<sup>170</sup> If applicable state law does not protect the lapsed portion from the beneficiary’s creditors, the lapsed portion may be subject to estate tax at the beneficiary’s death under IRC Sections 2038 and 2041.

- d. The BDOT technique has a greater safety valve than the SIDGT or a LAIDGT for protecting the seller, since the seller both has withdrawal rights in and is a beneficiary of the BDOT.
- e. The BDOT technique can be used to transfer assets from a trust that is a non-grantor trust to a newly created trust.

Can a trust be a deemed owner of another trust under IRC Section 678 under the treasury regulations? Yes.

- (1) Treas. Reg. § 1.671-2(a)(6), Example 8 confirms that under IRC Section 678(a)(1) a trust can be the deemed income tax owner of another trust.

That example in the regulations provides as follows:

"Example 8. G creates and funds a trust, T1, for the benefit of G's children and grandchildren. After G's death, under authority granted to the trustees, in the trust instrument, the trustees of T1 transfer a portion of the assets of T1 to another trust, T2, and retain a power to revoke T2 and revest the assets of T2 in T1. Under paragraph (e)(1) and (5) of this section, G is the grantor of T1 and T2. In addition, because the trustees of T1 have retained a power to revest the assets of T2 in T1, T1 is treated as the owner of T2 under section 678(a)."

- (2) PLR 201633021 (8/12/2016) also held that a trust can be a withdrawing income beneficiary of another trust that is designed to be a BDOT.

The key provisions of that PLR are as follows:

"Facts

...

The governing document for Trust 1 (Trust 1 Agreement) authorizes Trustee, at any time, to distribute all of any portion of the net income or principal or both of Trust 1 directly to any one or more of the Beneficiaries living at the time of such distribution or to the trustees of any trust of which such Beneficiary is a beneficiary.

Pursuant to the authority granted to the Trustee under the Trust 1 Agreement, the Trustee proposes to transfer funds from Trust 1 to Trust 2 which also benefits Beneficiaries. Beneficiaries' rights to distributions under the Trust 2 agreement are the same as those under the Trust 1 Agreement.

The governing document of Trust 2 (Trust 2 Agreement) provides that Trust 1 retains the power, solely exercisable by Trust 1, to revest the net income of Trust 2 in Trust 1; provided, however, that such power shall lapse on the last day of such calendar year.

The Trust 2 agreement provides that income includes (i) any dividends, interest, fees and other amounts characterized as income under § 643(b) of the Code, (ii) any net capital gains realized with respect to assets held less than twelve months, and (iii) any net capital gains realized with respect to assets held longer than twelve months.

## Law and Analysis

...

Section 1.671-2(e)(5) provides that if a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. *See also* § 1.671-2(e)(6), Example 8.

...

## Conclusion

Trust 1 will be treated as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a). Accordingly, Trust 1 will take into account in computing their tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to which enter into the computation of distributable net income. Additionally, Trust 1 will also take into account the net capital gains of Trust 2." (Emphasis added.)

### (3) The technique.

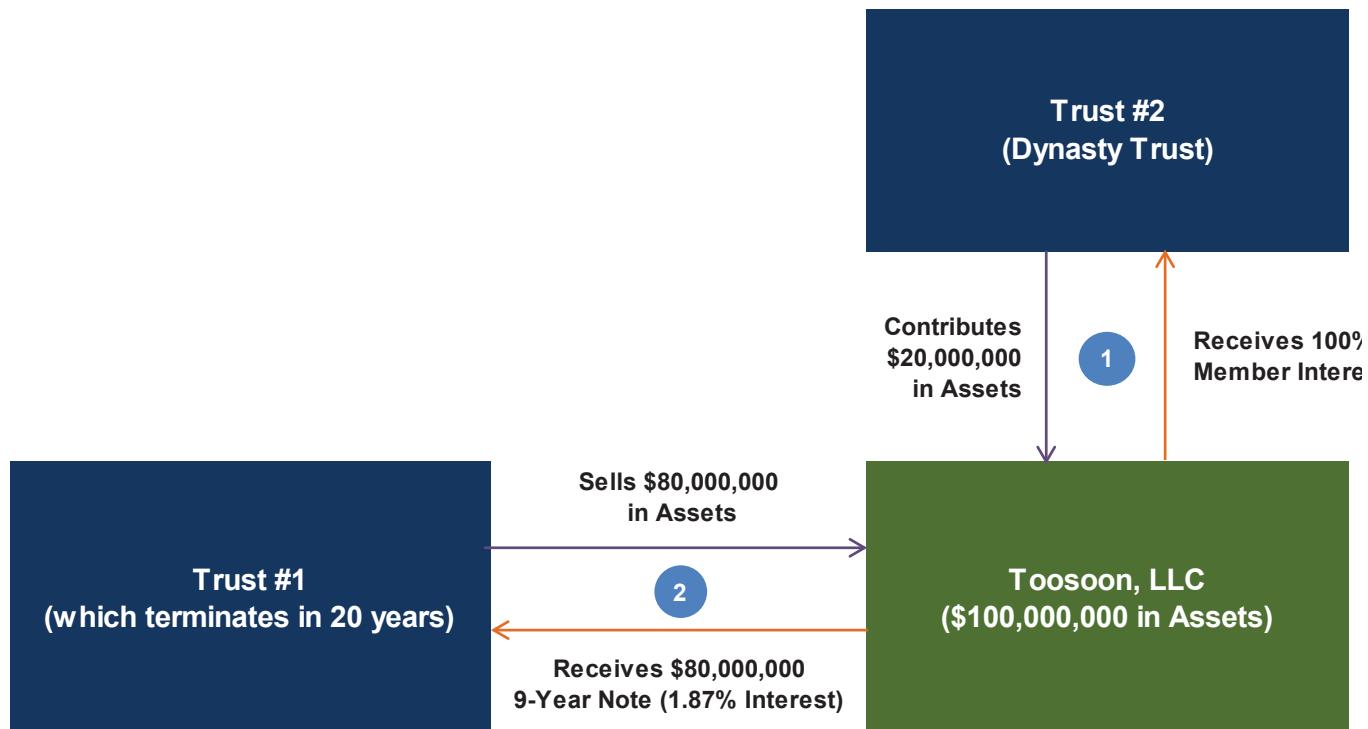
Consider the following example:

Example 15: The Trustee of a Trust Which Will Actuarially Terminate in About 20 Years and Which is the Deemed Income Tax Owner of a Long-Term Dynasty Trust, Could Sell Its Assets to a Single Member LLC That is Created By the Trustee of Long-Term Dynasty Trust

*Tom Toosoon is a trustee of a trust which will actuarially terminate in about 20 years ("Trust 1"). "Trust 2" is a dynasty trust in which Trust 1 is the deemed income tax owner because the creation of Trust 2 gave Trust 1 the right to vest income of Trust 2 in a manner which made Trust 1 the deemed income tax owner. The beneficiaries of Trust 1 are also the initial beneficiaries of Trust 2 and each of those individuals has a broad special testamentary power of appointment over their beneficial share of trust 2.*

*Tom Toosoon, as trustee of Trust 1, a non-grantor trust, sells trust assets for a nine-year note that pays the AFR rate, to an LLC that is disregarded for income tax purposes that is created by Trust 2 (which is also a non-grantor trust). The note is designed to be refinanced from time to time. The beneficiaries of Trust 1 ask Tom Toosoon to assume the value of Trust 1 is \$80,000,000 and the value of Trust 2 is \$20,000,000. The assets of Trust 1 and Trust 2 will earn on the average 7.4% a year before income taxes. Of that 7.4% return, the beneficiaries of Trust 1 ask Tom Toosoon to assume 0.6% of that return will be taxed as ordinary income, 2.4% of the return will be tax-free and 4.4% of the return will be taxed as capital gains with a 30% turnover*

rate. The beneficiaries also assume that on the average 3% of what the value of Trust 1 would be if a sale is not made will be distributed out of Trust 1 to the beneficiaries. The beneficiaries assume no distributions will be made out of Trust 2 to the beneficiaries, unless Trust 1 is no longer in existence. The technique could be illustrated as follows:



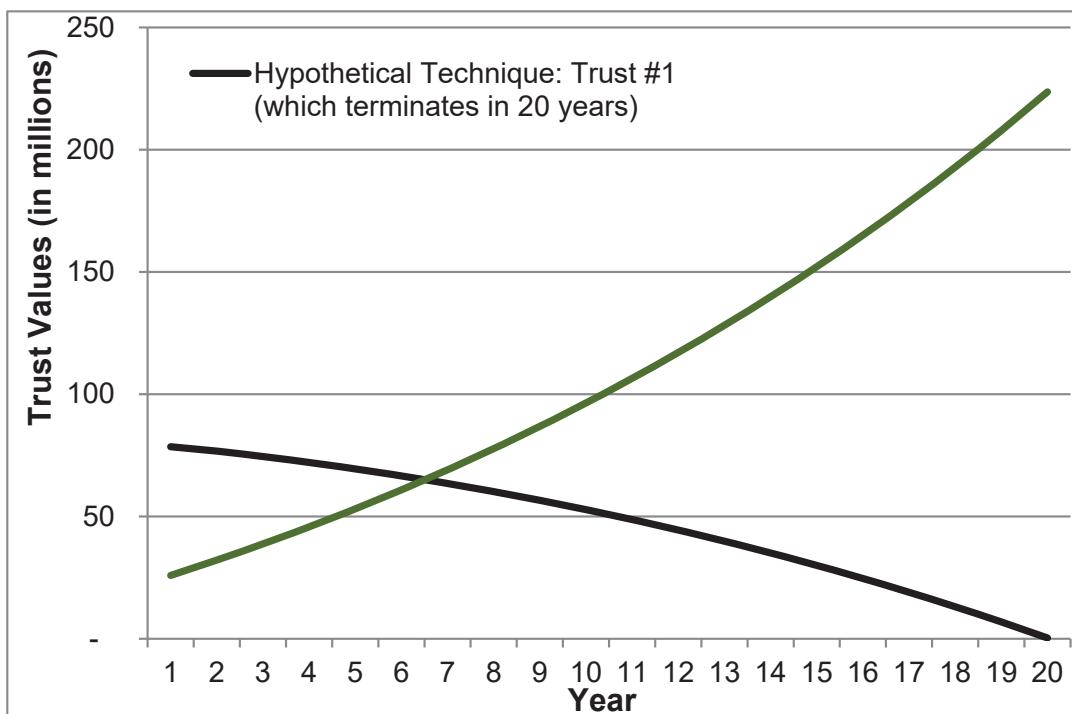
#### (4) Advantages of the technique

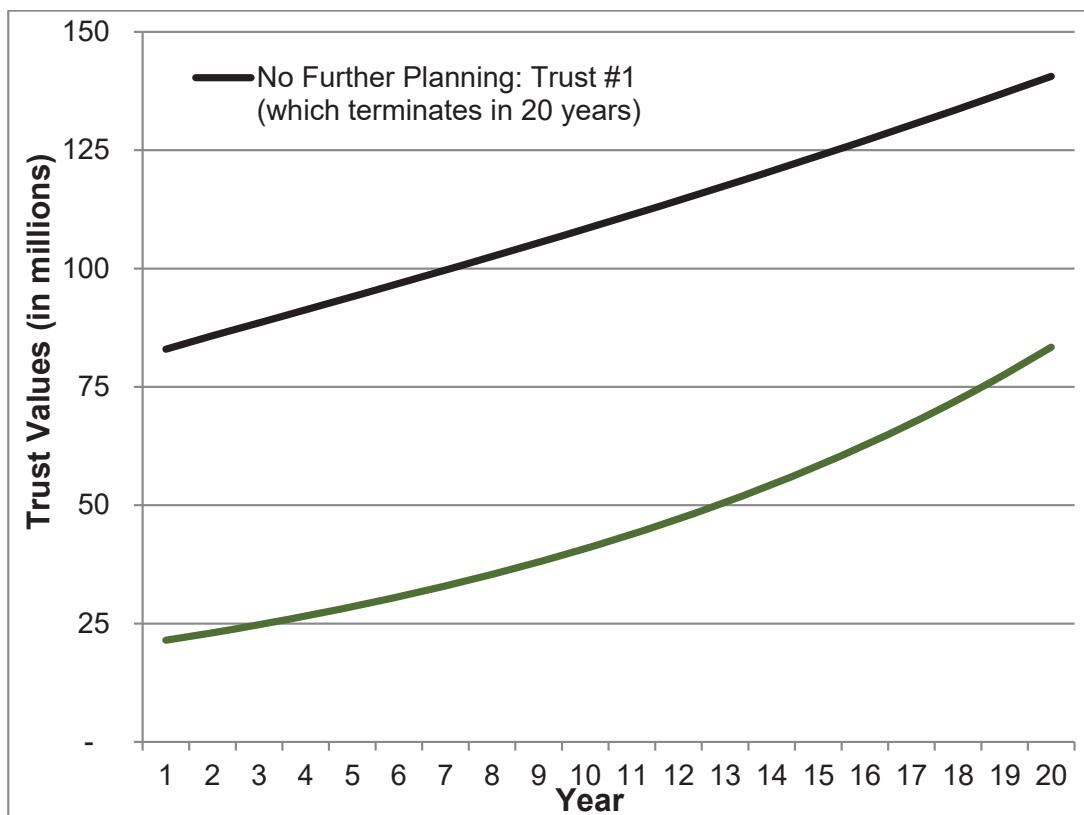
- (a) Wealth will be indirectly transferred from Trust 1 to Trust 2 because Trust 1 is paying all of the income taxes generated by the trust assets by both Trust 1 and Trust 2 and because the earnings and growth of the combined trusts is projected to be much higher than the projected 1.87% interest carry.

The table below (also see attached Schedule 11) demonstrates the significant transfer from Trust 1 to Trust 2 that could occur over 20 years.

Table 12

|  | Trust #1<br>Beneficiaries | Trust #2<br>Beneficiaries |
|--|---------------------------|---------------------------|
| <b>20-Year Future Values</b>   |                           |                           |
| No Further Planning  | \$140,597,305             | \$83,390,317              |
| Hypothetical Technique Using BDOT and Sale from One Trust to Another Trust | \$334,556                 | \$223,653,066             |
| <b>Present Values (discounted at 2.5%)</b>                                 |                           |                           |
| No Further Planning  | \$85,802,450              | \$50,890,687              |
| Hypothetical Technique Using BDOT and Sale from One Trust to Another Trust | \$204,170                 | \$136,488,967             |





- (b) The BDOT combined with a sale from one trust to another may be superior to the technique of decanting from one trust to another trust. In some states the option of a successful decanting of a particular trust may not exist.

(5) Consideration of the technique.

- (a) The technique has the considerations of using the BDOT technique. *See* discussion *supra* Section VI.B.7.
- (b) The technique could be disadvantageous to the beneficiaries of the withdrawing power selling trust unless they are also beneficiaries and/or the objects of their bounty are beneficiaries of the trust.

5. A BDOT may be able to be used as an exit strategy from a closely held family C corporation.
  - a. The technique.

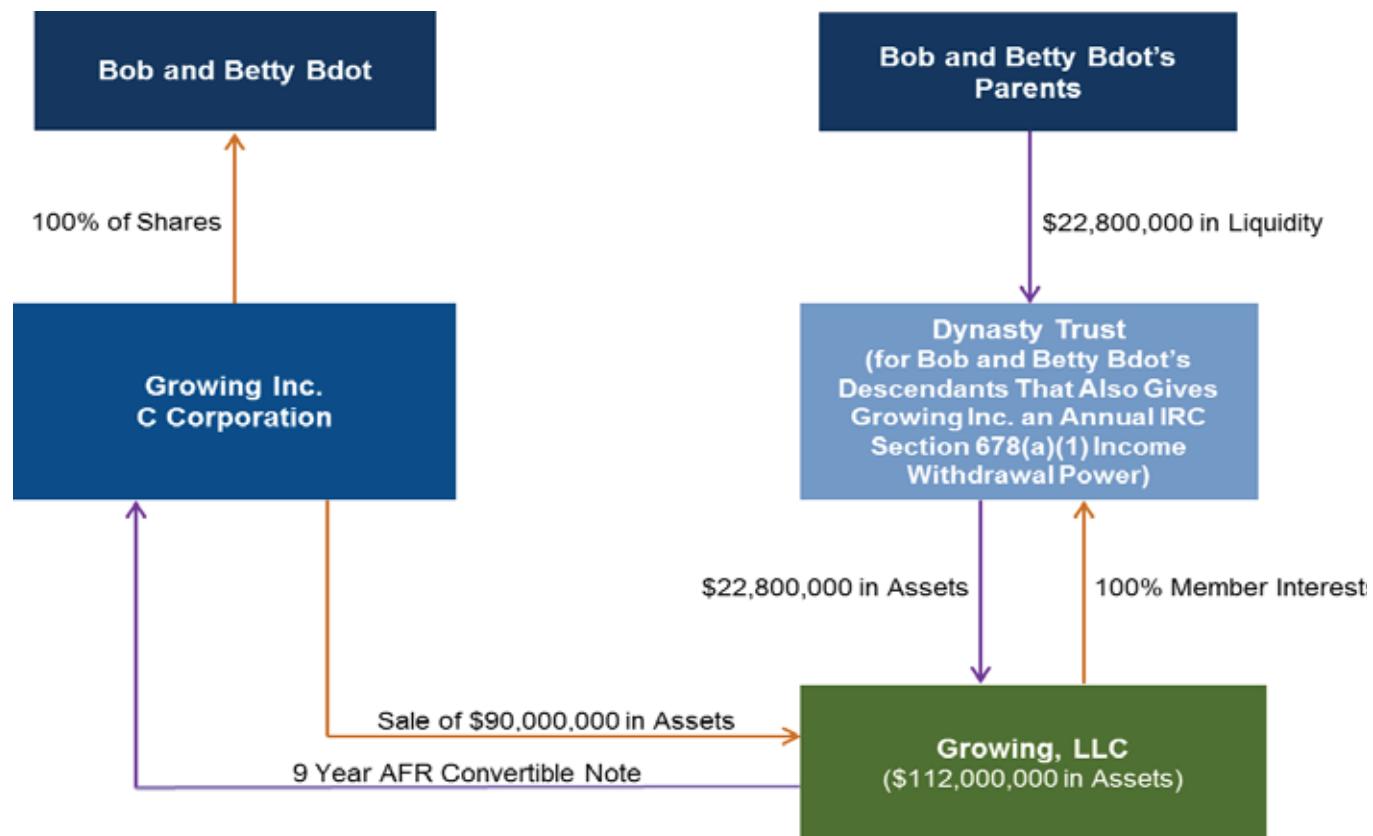
Consider the following example.

Example 16: Using a BDOT as an Exit Strategy from a C Corporation

Growing Inc. is owned by Bob and Betty Bdot. Growing Inc. has \$90,000,000 in assets, but desires additional capital. Growing Inc. is projected to annually earn 10% a year before income taxes. Third parties could create a dynasty trust (e.g., parents of Bob and Betty) for the discretionary benefit of Bob and Betty's descendants, and also gives Growing Inc. the annual lapsing right to withdraw all of the net taxable income of the trust. The dynasty trust created by Bob and Betty's parents does not have provisions which would make it a grantor trust to Bob and Betty's parents. Growing Inc. has the right to satisfy that annual lapsing withdrawal right out of all portions of the BDOT. Also consider the key assumptions infra Section III.E.3.b. The provisions of the BDOT provide that an independent trustee could terminate the C corporation's future annual lapsing rights in future years.

The BDOT creates a single member LLC. Growing Inc. through a sale, or sales, for full consideration, transfers the assets of Growing Inc. to the BDOT created LLC. The consideration that Growing Inc. receives is a note that pays an AFR interest that can be convertible at any time to that amount of member interests that are equal in value to the then outstanding principal of the note.

Example 16 is illustrated below:



b. Key Assumptions of Example 16.

- The note payable to Growing Inc.'s grantor trust could be convertible to that amount of member interests of Growing, LLC that are equal to the outstanding principal of the note.
- It is assumed that the interest rate during the life of the loan, and any refinancing of the loan, will be 2.38%.
- It is assumed the LLC assets will annually grow at 10% a year with 4 ½% of that return being taxed at ordinary rates for the next 30 years.
- It is assumed that the note will annually be serviced in a manner that allows Growing Inc. to pay its corporate income taxes.
- It is assumed that the annual lapsing withdrawal right of Growing Inc. will never exceed 5% of the net value of the BDOT. If there is ever a sale of the assets of Growing, LLC, Growing Inc. will have a significant withdrawal right, assuming the independent trustee has not, by the time of the sale, eliminated the withdrawal right for that sale year. If the withdrawal right has not been eliminated by the independent trustee's actions, Growing Inc. could withdraw the proceeds of the realization of the capital and other taxable income above 5% of the net value of the BDOT. After paying 21% corporate taxes on that income, the net amount could perhaps be loaned by Growing Inc. to Growing, LLC.

c. Results under the key assumptions of Example 16.

- Under Treas. Reg. § 25.2511-1(h)(1), Bob and Betty would be deemed donors for transfer tax purposes to the BDOT if Growing Inc. does not withdraw any taxable income in any taxable year that exceeds 5% of the net value of the BDOT.
- See the table (Scenario A) below (also see attached Schedule 12). In 30 years, Growing Inc. C Corporation will have very few assets in comparison to Growing, LLC.

Table 13

| Bob & Betty Bdot's                         |                                | Consumption     |                                 | IRS Income Tax  |                                 | Income Tax Liability of Estate |                             | Cost Benefit of Technique (9) | Total (10)                      |
|--|--------------------------------|-----------------|---------------------------------|-----------------|---------------------------------|--------------------------------|-----------------------------|-------------------------------|---------------------------------|
| Children (1)                               | Children and Grandchildren (2) | Direct Cost (3) | Investment Opportunity Cost (4) | Direct Cost (5) | Investment Opportunity Cost (6) | Embedded Corporate Tax (7)     | IRS Estate Tax (at 40%) (8) |                               |                                 |
| <b>30-Year Future Values</b>               |                                |                 |                                 |                 |                                 |                                |                             |                               |                                 |
| No Further Planning, Except Gift to GST    | \$852,488,158                  | \$165,875,648   | \$43,902,703                    | \$87,042,815    | \$150,922,210                   | \$294,358,049                  | \$131,157,229               | \$251,663,715                 | \$0 \$1,977,410,527             |
|  | \$1,018,363,806                |                 | \$130,945,518                   |                 | \$445,280,259                   |                                | \$382,820,944               |                               |                                 |
| Hypothetical Technique - Scenario A*       | \$22,282,902                   | \$1,524,453,937 | \$43,902,703                    | \$87,042,815    | \$163,218,176                   | \$325,384,223                  | \$0                         | \$14,855,268                  | (\$203,729,498) \$1,977,410,527 |
|  | \$1,546,736,839                |                 | \$130,945,518                   |                 | \$488,602,399                   |                                | \$14,855,268                |                               |                                 |
| Hypothetical Technique - Scenario B**      | \$125,646,428                  | \$1,044,047,423 | \$43,902,703                    | \$87,042,815    | \$251,783,492                   | \$560,671,528                  | \$0                         | \$68,045,635                  | (\$203,729,498) \$1,977,410,527 |
|  | \$1,169,693,851                |                 | \$130,945,518                   |                 | \$812,455,021                   |                                | \$68,045,635                |                               |                                 |
| <b>Present Values (Discounted at 2.5%)</b> |                                |                 |                                 |                 |                                 |                                |                             |                               |                                 |
| No Further Planning, Except Gift to GST    | \$406,417,493                  | \$79,060,002    | \$20,930,293                    | \$41,497,025    | \$71,951,060                    | \$140,333,047                  | \$62,528,250                | \$119,978,835                 | \$0 \$942,716,004               |
|  | \$485,497,495                  |                 | \$62,427,318                    |                 | \$212,284,106                   |                                | \$182,507,085               |                               |                                 |
| Hypothetical Technique - Scenario A*       | \$10,623,211                   | \$726,772,263   | \$20,930,293                    | \$41,497,025    | \$77,813,072                    | \$155,124,548                  | \$0                         | \$7,082,140                   | (\$97,126,548) \$942,716,004    |
|  | \$737,395,474                  |                 | \$62,427,318                    |                 | \$232,937,620                   |                                | \$7,082,140                 |                               |                                 |
| Hypothetical Technique - Scenario B**      | \$59,901,016                   | \$497,741,972   | \$20,930,293                    | \$41,497,025    | \$120,035,938                   | \$267,296,050                  | \$0                         | \$32,440,259                  | (\$97,126,548) \$942,716,004    |
|  | \$557,642,987                  |                 | \$62,427,318                    |                 | \$387,331,968                   |                                | \$32,440,259                |                               |                                 |

\*Growing Inc. enters into a non-taxable sale of its assets to Growing, LLC which is owned by a dynasty trust.

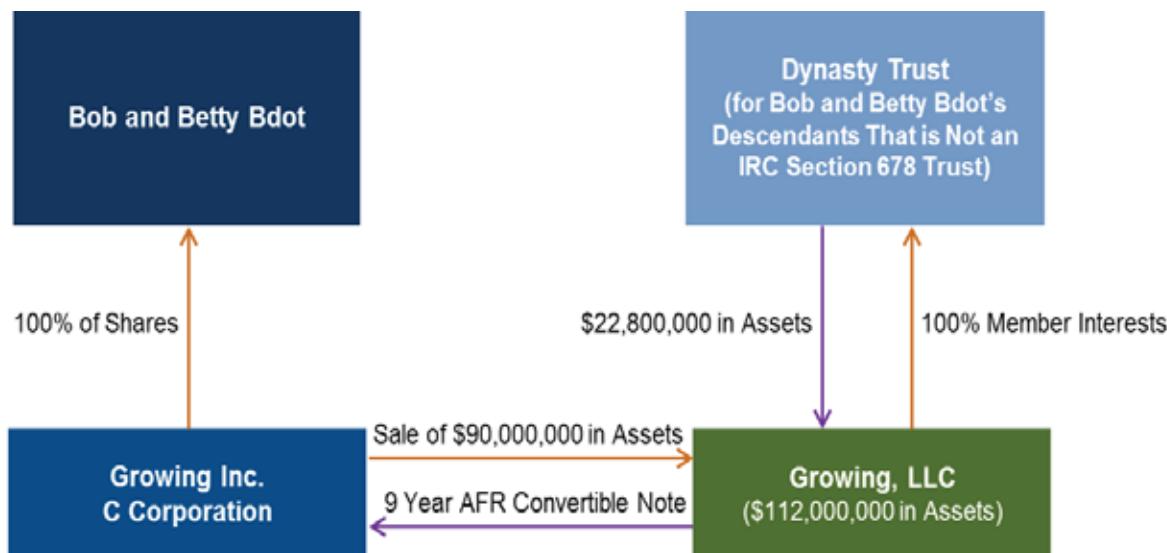
\*\*Growing Inc. enters into a taxable sale of its assets to Growing, LLC which is owned by a dynasty trust.

d. Considerations of the technique.

- (1) There is no direct authority that the technique works.
- (2) If the technique does work, it may only be attractive in certain intra-family transfer situations.
- (3) IRC Sections 269 and 482 would not appear to apply.

However, the IRS, under equitable tax principles, may be able to re-characterize the transaction as a taxable sale to the LLC and that the c corporation is not the income tax owner of the LLC. however, in general, the courts are reluctant to allow the IRS to use equitable tax doctrines to override the benefits the internal revenue code clearly intends.<sup>171</sup> in other words, the IRS may be able to re-characterize the transaction as follows:

<sup>171</sup> In general, the courts are reluctant to allow the IRS to use equitable tax doctrines to override the benefits the Internal Revenue Code clearly permits. *See Getlitz v. Comm'r*, 531 US 206 (2001) (the Supreme Court found for the taxpayer in which a literal application of the rules under subchapter S in the context of cancellation of debt income provided both a basis increase and an exclusion from income); *Summa Holdings, Inc. v. Comm'r*, No. 16-1712 (6th Cir. 2017); *Wright v. Comm'r*, 804 F.3d 877 (6th Cir., 2016); and *Pilgrim's Pride Corp. v. Comm'r*, 779 F.3d 311 (5th Cir., 2015).



However, even if the IRS is able to re-characterize the transaction, the table above notes that the results are better than no further planning.

- (4) If no further planning occurs except a gift to the GST trust, see the results in table above.

## 6. Other Uses of Beneficiary-Owned Trusts.

- a. Interest-free loans to beneficiary.

### (1) The potential problem.

The treatment of a below-market loan from a trust to a beneficiary of the trust to whom distributions of income may or are required to be made is not clear. Although beneficiary loans are not specifically listed in the portion of IRC Section 7872 that lists the below-market loans to which IRC Section 7872 applies, there is some concern that the IRS could take the position that they are "tax avoidance loans." A tax avoidance loan is any below-market loan one of the principal purposes of which is the avoidance of any Federal tax. It could be argued that the principal purpose of an interest free beneficiary loan is to provide the beneficiary with interest-free enjoyment of the loaned funds. But the trustee could, if income taxes were not considered, arrange for the same interest-free enjoyment by distributing the interest paid by the beneficiary back to the beneficiary.

### (2) The beneficiary-owned trust solution.

If the beneficiary is treated as the owner of a trust, loans from the trust to the beneficiary should be ignored for income tax purposes. If it is undesirable to give the beneficiary complete income tax ownership of the trust, ownership could be limited to the income from that portion of the trust that the trustee intends to lend to the beneficiary.

b. Beneficiary ownership of state source income.

(1) The Potential problem.

At least two states, New Jersey and New York, impose state income tax on trusts that were funded by state domiciliaries if the trusts earn income that is sourced within the state.<sup>172</sup> When trusts invest in pass-through entities, it is difficult to ensure that at least some small portion of the trust's share of the pass-through entities' income will not consist of income sourced in one of these states.

(2) The beneficiary-owned trust solution.

Give one of the beneficiaries of the trust a withdrawal power over all income sourced in New York, in the case of a trust funded by a New York domiciliary, or sourced in New Jersey in the case of a trust funded by a New Jersey domiciliary. If this is done, IRC Section 678 should cause the trust income sourced in the applicable state to be treated as owned for income tax purposes by the beneficiary, not the trust. When the trust files its annual Form 1041, it will not include in its gross income the state sourced income treated as owned by the beneficiary. It will show that portion of the income as owned by the beneficiary on a separate schedule attached to the Form 1041.

(a) Difficulty that source income may not be traceable.

Practical problems may be suggested by the fact that although the pass-through entity will show the trust as having received state sourced income, the trust is unlikely to ever receive a distribution clearly traceable to that income. That raises the question as to how the beneficiary's withdrawal right can have any economic significance. One solution is to have the beneficiary sell his or her right to receive the state sourced income back to the trust. Because the beneficiary is required to include the state sourced income in his or her gross income, the beneficiary will have a basis in the right to that income equal to the amount of the income. The payment from the trust to the beneficiary in exchange for that right should not cause the beneficiary to recognize any additional income.

c. Consider using the BDOT technique, in combination with an accumulation trust, to facilitate IRA planning for descendants.

(1) After passage of the Secure Act, IRAs must terminate in 10 years for descendants who are older than the age of majority.

(2) A conduit trust for a descendant who is older than the age of majority will terminate in 10 years.

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<sup>172</sup> NY Tax L. § 605 (b)(3)(D); NJSB §§ 54A:1-2(o)(2)–(3), 54A:2-1(b)(6); instructions to 2018 Form NJ-1041 at 1, 24.

- (3) An accumulation trust for a descendant will not have to terminate in 10 years. However, the balance in the subject IRA will all be paid to the accumulation trust after 10 years which will be taxed at the trust's high tax rate.
- (4) If the accumulation trust for the descendant is designed to be a BDOT, the IRA proceeds will be taxed at the descendant's income tax rates, which may be much lower than the trust's income tax rates.
- (5) In future years the taxable income of the trust will also be taxable at the descendant's income tax rates, which may be much lower than the trust's income tax rates.
- (6) If the beneficiary withdraws from the trust only that amount necessary to pay income taxes associated with the trust, the beneficiary will maximize the creditor protection and other benefits of the trust.

d. Using the springing BDOT technique to lengthen the benefit of a grantor trust.

- (1) A grantor trust could be drafted to provide that the trust's beneficiary (which could be the grantor's spouse) becomes an "income withdrawal beneficiary" after the grantor's death.
- (2) If this technique is used, the grantor should also bequeath any outstanding notes in which the grantor is the creditor to the "income withdrawal beneficiary."

7. Considerations for all BDOT techniques.

a. Avoiding a wealth transfer tax caused by lapse of a general power.

In order to receive the lapse of power transfer tax protection of IRC Sections 2041(b)(2) and 2514(e)(2), it is important that the withdrawal power applies against all of the income earned by all of the BDOT trust assets and can be satisfied from the trust's accounting income, sale proceeds of the corpus of the BDOT trust, and corpus of the BDOT trust. Because the beneficiary has a right to withdraw trust income, IRC Section 2036(a) could apply to a contribution to the trust by the beneficiary other than a bona fide sale for full and adequate consideration. It is therefore important that any withdrawable, but untaken, BDOT funds be protected from being considered a contribution by the beneficiary of the BDOT for transfer tax purposes. The requirements under the tax law for those withdrawable, but untaken, BDOT funds to not be considered a transfer for transfer tax purposes are: (i) those BDOT funds cannot exceed more than 5% of the value of the property of the BDOT; (ii) those BDOT funds could have been paid from the entire property, or proceeds from the property, of the BDOT, and (iii) creditors cannot

reach those BDOT funds after the right to withdraw them expires. See below for a discussion of the third requirement of whether creditors can reach those fund.

In order to meet the statutory requirements of IRC Sections 2041(b)(2) and 2514(e)(2), the withdrawable, but untaken, funds cannot exceed 5% of the value of the property of the BDOT. If the net taxable income is projected to exceed 5% of the value of the property of the BDOT (in many years of most BDOTs, that would not be the case) the beneficiary could withdraw that excess net taxable income above that value equal to 5% of the BDOT. For instance, if it is assumed the net taxable income of the BDOT is equal to an amount that is 6% of the value of the corpus of the BDOT, the beneficiary could withdraw one-sixth of the net taxable income of the trust. In that fashion the withdrawable, but untaken BDOT funds will be equal to the 5% safe harbor of IRC Sections 2041(b)(2) and 2514(e)(2). Secondly, the use of hanging powers of withdrawal could also mitigate the transfer tax issue.

Rev. Rul. 66-87<sup>173</sup> highlights the importance of making sure the BDOT funds available for withdrawal can be paid from the entire property and/or proceeds of the property of the BDOT. That revenue ruling focused on the effect of a power to withdraw accounting income (not net taxable income from all sources including capital gains sales) that was not withdrawn. The revenue ruling concluded the 5% lapse protection is calculated based on the amount of that accounting income only and is not calculated based on the corpus of the requisite trust. In issuing Revenue Ruling 66-87, Treasury assumed that the trust document did not permit the withdrawal powers to be satisfied from all of the trust assets. *See* Treas. Reg. § 25.2514-3(c)(4).

In light of the above considerations, the beneficiary of a BDOT who does not wish to be out of pocket gift taxes or income taxes on a net basis, may wish to notify the trustee of the BDOT, in any calendar year, that he or she desires to withdraw in satisfaction of the beneficiary's withdrawal right that amount of the accounting income, proceeds of corpus sales and/or corpus that is the greater of (i) that amount of net taxable income that the beneficiary has previously notified the trustee that he or she wishes to withdraw; (ii) that amount of net taxable income that is equal to the income taxes owed by the beneficiary of the BDOT; or (iii) that amount of net taxable income that exceed 5% of the value of the corpus of the trust.

b. Adverse transfer tax consequences if creditors can reach BDOT assets.

Creditors might, under state law, have the right to reach BDOT assets either because withdrawals were not taken or because a sale was for inadequate consideration. In both of those circumstances the BDOT beneficiary would become a deemed settlor of a portion of the BDOT in addition to the original settlor. The amount that could be included in the BDOT beneficiary's estate, if the sale is for inadequate consideration may be considerable, depending on the growth of the asset that is sold between the time of the sale and the beneficiary's death. Because of the operation of IRC Sections 2036 and 2043, the full value of the sold asset will be included in the beneficiary's estate minus the value of the note at the time of the sale. In that event, the part that

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<sup>173</sup> Rev. Rul. 66-87, 1966-1 C.B. 217.

the creditors can reach will be taxable in the BDOT beneficiary's estate, whether or not that BDOT beneficiary has those potential creditors.

Even if an assigning beneficiary does not have any current creditors, or any future creditors, if the assigning beneficiary *could* create a creditor relationship under which part of the trust assets, either under state law or federal bankruptcy law, would be available to satisfy the creditor obligation, that part of the trust will be included in the assigning beneficiary's estate for estate tax purposes. In addition to arguing that the sale is not for adequate and full consideration for gift tax purposes, the IRS could take the position the sale is not adequate for creditor protection purposes under the relevant state property law.

However, see the discussion *supra* Section V.B.5. Also, almost all states have legislation that protects against the BDOT beneficiary's creditors reaching the withdrawable, but untaken, BDOT funds. Not only do the states that permit self-settled trusts protect against those potential creditors, but almost all states have legislation that protects against creditors reaching lapsed withdrawals that are 5% or less of the value of the corpus of a trust. Secondly, a BDOT could be drafted to allow an independent trustee or a protector to remove the withdrawal power that is inherent in a BDOT trust structure in future years.

Of course, independent of creditor rights considerations, a sale for inadequate consideration by the withdrawing beneficiary will include the full value of the BDOT at the withdrawing beneficiary's death minus the original value of the note receivable because of the withdrawing beneficiary's retained income rights. *See* IRC Sections 2036(a)(1) and 2043. In order to avoid the consequences of a sale for inadequate consideration, strong consideration should be given to the BDOT beneficiary using a defined value allocation assignment or a defined dollar transfer when he makes the sale.

c. The sale of assets to a BDOT has most of the considerations of a LAIDGT or SIDGT, with the following exceptions,

- (1) There is less danger that the sale to a BDOT will be a taxable gift because of the presence of the seller's beneficial interest and special power of appointment over the BDOT, may make the gift an incomplete gift.
- (2) The disregarded income tax status can remain longer because of the seller's beneficial interest in the trust, which is not the case with the SIDGT or LAIDGT techniques.

There is a greater safety valve protection for the BDOT seller's lifestyle needs because the seller is also a beneficiary of the BDOT.

- (3) There may be a greater opportunity to convert the retained note to a private annuity.

- d. It may be important to have an independent trustee of the BDOT whose only power is to remove the withdrawal beneficiary's power to withdraw net taxable income for a future year or years.

An independent trustee exercising that power could protect the trust from the beneficiary's creditors and protect the trust from a significant withdrawal if it is anticipated that there will be taxable income from a future significant realization event. However, if the independent trustee has not negated the beneficiary's withdrawal power, and if there is a significant realization event, the beneficiary could withdraw that amount of taxable income above 5% of the trust assets, pay the associated tax and then loan the difference back to the BDOT.

- e. Post-mortem uses of a sale to an LLC owned by a BDOT.

- (1) BDOT trusts created by deceased spouse for the surviving spouse.

In standard credit shelter trust planning, both the credit shelter trust and the QTIP marital deduction trust could be designed to be a BDOT for the benefit of the surviving spouse; the credit shelter trust could contribute its assets to an LLC; and, after that contribution, the QTIP marital deduction trust could sell its assets to the LLC owned by the credit shelter trust.

- (2) The technique.

If both the credit shelter trust and the QTIP marital deduction trust are designed to be BDOTs with respect to the surviving spouse, then any sales by the QTIP marital deduction trust to an LLC owned by the two trusts will be ignored for income tax purposes. An LLC could be created by the credit shelter trust and perhaps the surviving spouse. If the QTIP marital deduction trust sells its asset to the LLC owned by a credit shelter trust that sale will be ignored for income tax purposes and all of the future collective appreciation above the interest owed to the QTIP marital deduction trust will pass to the LLC owned by the credit shelter trust. The surviving spouse will pay all of the collective income taxes associated with the structure. The surviving spouse could look to the assets of the QTIP marital deduction trust for her living expenses and income tax expenses, which could deplete the QTIP marital deduction trust during the surviving spouse's lifetime, if those distributions exceed the QTIP marital deduction trust's interest income. Consider the following:

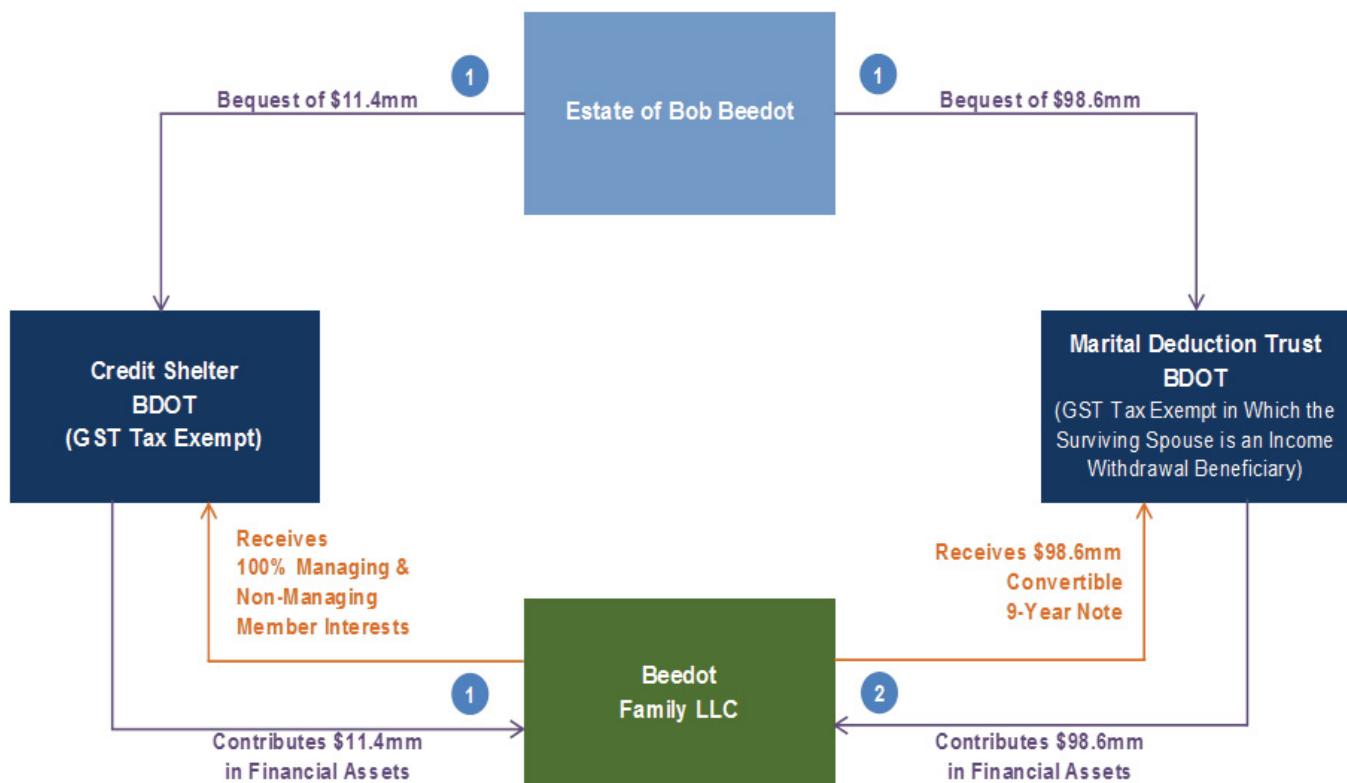
*Example 17: Designing Both a Credit Shelter Trust and a QTIP Marital Deduction Trust to Be a BDOT in Order to Use Leveraged Disregarded Trust Planning*

*Bob Beedot is married to Dot Beedot. Bob has been very successful and he has built a \$110,000,000 estate during their 50-year marriage. His first goal, if Dot survives him, is to totally provide for Dot. Upon Bob's death, Dot wishes for her remaining estate to pass in trusts to their descendants. Bob has never engaged in lifetime gifting strategies for a variety of reasons, one of which is that he has very low basis assets. Bob likes the protection, tax benefits and simplicity of the credit shelter trust and the QTIP marital deduction trust that could be*

created on his death. However, Bob is concerned that the credit shelter trust only protects about one-tenth of his net worth from future estate taxes and creditors. Bob is intrigued about the possibility of designing the credit shelter trust and the QTIP marital deduction trust to be BDOTs, and the use of sales between the trusts.

Bob tells his attorney, Youra Mathgeek, that Dot will need approximately \$1,000,000 a year (inflation adjusted) for her consumption needs. Bob asks Youra to make the following assumptions: his assets will annually earn 7.4% before income taxes with 0.6% of the return not being tax-free, 2.4% of the return being taxed at ordinary rates and 4.4% of the return being taxed at long-term capital gains rates (with a 30% turnover rate). Bob asks Youra to assume Dot will live for 10 years after his death.

Youra suggests to Bob that after his death the credit shelter trust could create a single member LLC with managing and non-managing interests (Transaction 1 below). The QTIP marital deduction trust could sell its assets to the LLC owned by the credit shelter trust (Transaction 2 below). Youra assumes a 30% valuation discount for the non-managing interests will be allowed. The structure, after completion, is illustrated as follows:



(3) Income tax and basis enhancing advantages of the technique.

(a) There is a step-up in basis of the deceased spouse's assets at his death. This technique is particularly advantageous for a taxpayer who has a low basis or a negative basis asset, because it does not require a

lifetime transfer of assets. There will be a step-up in basis that is equal to the fair market value of the assets.

- (b) There is an opportunity through using borrowing strategies from third party lenders for the surviving spouse to increase the basis of the family's assets during her lifetime.
- (c) All of the income tax and basis enhancing advantages of creating an IDGT are present with this technique.

**(4) Transfer tax advantages of the technique.**

- (a) Significantly more assets may be passed to the next generation by using this technique than using the exemption to fund a credit shelter trust that is taxed as a complex trust and a QTIP marital deduction trust that is taxed as a complex trust.

Using the synergies of a sale of the QTIP marital deduction assets to the credit shelter trust's LLC paying the notes with pre-income tax dollars, with the surviving spouse paying all of the income taxes. Youra's calculations indicate that \$31,209,383 in estate taxes could be saved with this technique, assuming Dot lives 10 years after the death of Bob in comparison to traditional credit shelter and QTIP planning. See the table below and attached Schedule 13.

**Table 14**

|  | Beneficiaries   |                                 | Consumption   |                             | IRS Income Tax |                             | Tax Liability of Estate    |                        | Total         |
|--|-----------------|---------------------------------|---------------|-----------------------------|----------------|-----------------------------|----------------------------|------------------------|---------------|
|  | Beedot Children | Beedot Children & Grandchildren | Direct Cost   | Investment Opportunity Cost | Direct Cost    | Investment Opportunity Cost | Embedded Capital Gains Tax | IRS Estate Tax (@ 40%) |               |
| <b>10-Year Future Values</b>   |                 |                                 |               |                             |                |                             |                            |                        |               |
| Traditional Credit Shelter Planning: first to die spouse creates a credit shelter trust with his unified credit and balance of estate goes to a QTIP marital deduction trust   | \$86,316,764    | \$33,626,679                    | \$11,203,382  | \$4,344,673                 | \$22,869,455   | \$8,306,361                 | \$401,492                  | \$57,544,509           | \$224,613,316 |
|  |                 |                                 | \$119,943,444 |                             | \$15,548,055   |                             | \$31,175,816               |                        | \$57,946,001  |
| Hypothetical Technique: first to die spouse creates a credit shelter trust, that is a BDOT, and a marital deduction trust, that is also a BDOT; the credit shelter trust creates an LLC; the marital deduction trust sells assets to the LLC | \$39,502,690    | \$107,033,451                   | \$11,203,382  | \$4,344,673                 | \$24,254,461   | \$8,306,361                 | \$3,633,172                | \$26,335,126           | \$224,613,316 |
|  |                 |                                 | \$146,536,141 |                             | \$15,548,055   |                             | \$32,560,822               |                        | \$29,968,298  |

(b) The surviving spouse's rights with respect to assets owned by the QTIP marital deduction trust and the credit shelter trust, and cash flows produced by those assets, are substantial.

(5) Considerations of the technique.

(a) This technique has the same considerations as the creation of a BDOT and a sale to an LLC owned by a BDOT.

(b) Like all leverage techniques, if the underlying assets stay flat or decline there is not any advantage to the technique and to the extent a gift tax exemption is used, the technique operates at a disadvantage, unless gross estate inclusion can be toggled on in order to restore gift tax exemption.

(c) The QTIP marital deduction trust must also give the surviving spouse the right to withdraw all the trust's accounting income for life in addition to giving the surviving spouse the right to withdraw the net taxable income for life.

A spouse's right to withdraw accounting income satisfies the regulations applicable to marital trusts, including QTIP trusts.<sup>174</sup> Another alternative is to give the surviving spouse the right to withdraw the net taxable income and to require the accounting income to be distributed. If accounting income is required to be distributed, and if the surviving spouse is also given the right to withdraw the net taxable income, does the trust remain a wholly grantor trust under IRC Section 678 because of the spouse's power to withdraw net taxable income? The answer should be yes, because the grantor trust rules prevail over the otherwise applicable trust rules.<sup>175</sup>

C. Sales to LLCs Owned by BDITs.

This section analyzes the advantages and considerations of a transferor selling assets to a third party created trust that generally only has \$5,000 of corpus (a "Beneficiary Defective Inheritor's Trust" or "BDIT"), that names the transferor as a beneficiary, and under which the transferor is considered the income tax owner; with the consideration of the sale being a note that is guaranteed by a grantor trust the transferor has previously created (the "\$5,000 BDIT Guaranteed Sale Technique"). The BDIT generally provides that the beneficiary has the right to withdraw the \$5,000 corpus when the trust is created by a third party and if the beneficiary does not exercise that withdrawal power that \$5,000 then passes to a trust in which distributions may be made to the beneficiary under an ascertainable standard and the beneficiary has a testamentary special power of appointment.

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<sup>174</sup> See Treas. Reg. §§ 20.2056(B)-5(f)(8) and 20.2056(B)-7(d)(2).

<sup>175</sup> See Treas. Reg. § 1.671-2(d).

1. What is the \$5,000 BDIT guaranteed sale technique?

A BDIT is a trust that is a grantor trust, not as to the trust's settlor (the "Settlor") but as to a trust beneficiary (the "beneficiary"). That is, the trust is specifically designed not to trigger any of IRC Sections 673, 674, 675, 676, 677 or 679, but intentionally to trigger IRC Section 678. The BDIT is an IRC Section 678 trust because of operation of IRC Section 678(a)(2).

Consider the following example:

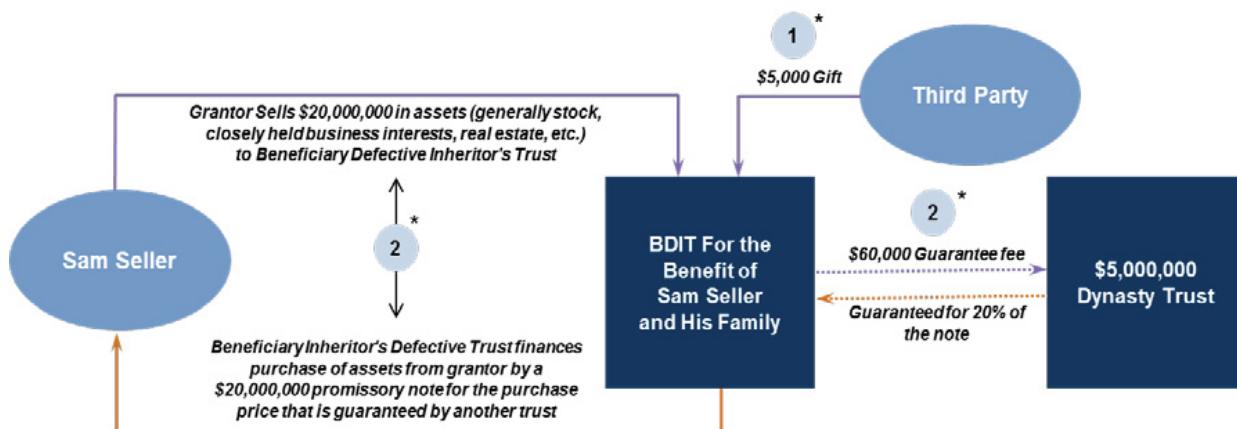
*Example 18: A Leveraged Sale By a Transferor to a \$5,000 BDIT in Which the Note is Guaranteed By the Transferor's Spouse or a Third-Party Trust*

*Sam Seller is the beneficiary of a BDIT that has \$5,000 as its sole asset and was created by a third party (Transaction 1 below). Sam has the power to withdraw \$5,000 when the trust is created. Sam does not exercise that power and the power lapses. The \$5,000 then passes to a trust in which distributions may be made to Sam under an ascertainable standard and under which Sam has a special power of appointment. That trust is designed not to be taxed in Sam Seller's estate. The trust is also designed where Sam Seller will pay all of the income taxes of the trust under IRC Section 678(a)(2).*

*Previously, Sam had contributed \$5,000,000 to a dynasty trust, which has the same beneficiaries as the BDIT, excluding Sam. Sam does not have a power of appointment over that \$5,000,000 dynasty trust. The \$5,000,000 dynasty trust is a grantor trust to Sam.*

*Sam sells assets equal to \$20,000,000 to the BDIT (Transaction 2 below). The \$5,000,000 generation-skipping trust guarantees the note up to \$4,000,000. The BDIT pays a guarantee fee equal to one and one-half percent of the \$4,000,000 guarantee, or \$60,000 a year.*

*The \$5,000 BDIT Guaranteed Sale technique is illustrated as follows:*



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

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2. Advantages of the \$5,000 BDIT guaranteed sale technique.

If the technique works, it has many of the same advantages as the sale to a grantor trust with the additional exit strategies of the transferor not only having access to the cash flow from the note, but also having access to the cash flow of the trust for his or her support and maintenance. Additionally, if the technique works, the transferor has the ability to change his or her mind as to future stewardship goals through the power of appointment mechanism.

In Rev. Proc. 2013-3 Section 4.01 (43), the IRS announced it would not rule on this transaction if “the value of the assets with the trust was funded by the grantor is nominal compared to the value of the property purchases.” Some of the considerations that may have led the IRS to the “no ruling” policy are noted below.

3. Transfer tax considerations of the \$5,000 BDIT guaranteed sale technique.

a. Does the Guarantee Fee Have Substance?

There is considerable pressure on the technique because of the need to pay the guarantee fee to the third party. A guarantee fee is probably necessary because the guarantor trust may not be the remainder beneficiary of the BDIT.<sup>176</sup> The IRS may question the substance of any guarantee fee in the hypothetical transaction illustrated above because of the significant ratio of that guarantee fee in comparison to the beginning corpus of the BDIT. Under this example, the corpus of the BDIT is \$5,000 and the guarantee fee to be paid is \$60,000 a year for the years the guarantee is outstanding. That is, the annual guarantee fee is twelve times the beginning corpus of the \$5,000 trust. The IRS may take the view that the substance of the transaction, despite the guarantee, is a sale for a \$20,000,000 note to a \$5,000 “naked” trust that, under these circumstances, may have gift tax consequences under IRC Section 2702 (if the beneficiary does not have a special power of appointment), and estate tax consequences under IRC Sections 2036 and 2038. Stated differently, the IRS may take the view that the risk/reward ratio of the guarantee fee by the BDIT is not commercial and there is no substance in the protection of the guarantee. The IRS’ position could be, in reality, there is little risk in the guarantee by the BDIT in comparison to its potential reward. The BDIT, under this example, has de minimis “skin” in the game. *Thus, the IRS may take the view that the substance of the integrated transaction inherent in the \$5,000 BDIT Guaranteed Sale is that, under equitable tax principals, two gifts for a total of \$5,005,000 were made to a dynasty trust that has two grantors (i.e., one grantor contributed \$5,000,000 and one grantor contributed \$5,000), followed by a sale of \$20,000,000 in financial assets to that dynasty trust, whose terms provide that the dominant grantor retains certain beneficial interests and certain powers to change the trust.*

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<sup>176</sup> See PLR 9113009 (Dec. 21, 1990), which was withdrawn for other reasons; *see also* Martin M. Shenkman, “Role of Guarantees and Seed Gifts in Family Installment Sales,” 37 Estate Planning 3 (Nov. 2010).

- b. Additional discussion of the transfer tax issues with the \$5,000 BDIT guaranteed sale technique.
  - (1) In general.

Often (though not always) the purpose of creating a BDIT is to enable the beneficiary to sell property to the trust without incurring a capital gains tax, because the trust is a grantor trust as to the beneficiary, removing subsequent appreciation of the sold property from the beneficiary's gross estate. Of course, the beneficiary could sell property to a grantor trust of his own creation without capital gains tax, and doing so has become a standard estate planning technique. The advantage of the BDIT, if it works, is that the beneficiary may have interests in and powers over the BDIT that the beneficiary could not have with respect to an ordinary, self-settled grantor trust, without causing the trust property to be included in the beneficiary's gross estate, because these interests and powers will be treated as conferred upon the beneficiary by the settlor of the trust, rather than retained by the beneficiary.<sup>177</sup>

(2) Interests and powers of the beneficiary.

The proponents of the \$5,000 BDIT Guaranteed Sale Technique assert that the beneficiary can have various interests and powers in the trust without causing inclusion in the beneficiary's gross estate. That is, the beneficiary's interests and powers will be tested under IRC Section 2041 rather than IRC Sections 2035 and 2038.<sup>178</sup> If that is so, the beneficiary can have a limited testamentary power of appointment over the trust and the power will not cause inclusion, whereas the same power retained by the beneficiary in a trust he creates would cause inclusion under IRC Section 2038. Similarly, the beneficiary may have a power of withdrawal subject to an ascertainable standard (and, as we shall see, such a power may be helpful to preserve grantor trust status). Under IRC Section 2041 a power exercisable in favor of the power holder does not cause inclusion if it is subject to an ascertainable standard. Under IRC Sections 2036 and 2038, such a power may cause inclusion, if the beneficiary is the grantor of the trust.<sup>179</sup> Also,

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<sup>177</sup> Oshins, Brody, and McBride, "The BDIT: A Powerful Wealth Planning Strategy When Properly Designed and Implemented," Lisi Estate Planning Newsletter 1824 (June 22, 2011), at <http://www.leimbergservices.com>; Gorin, "Beneficiary Grantor Trusts: A New Paradigm for Transferring Businesses," paper prepared for the ACTEC Business Planning Committee Summer 2011 Meeting (a shorter version is *A Balanced Solution*, Trusts & Estates 28-33 (May 2011)); Galant, "Beneficiary Grantor Trusts: Overview of Selected Issues," paper prepared for the ACTEC Business Planning Committee Summer 2011 Meeting; Blattmachr and Zeydel, "PLR 200449012 – Beneficiary Defective Trust(sm) Private Letter Ruling," Lisi Estate Planning Newsletter 1559 (Dec. 10, 2009), at <http://www.leimbergservices.com>; Oshins, Alexander, and Simmons, "The Beneficiary Defective Inheritor's Trust® ("BDIT"): Finessing the Pipe Dream," CCH Practitioner's Strategies (Nov. 2008); Richard A Oshins & Noel Ice, "The Inheritor's Trust™ Preserves Wealth as Well as Flexibility," 30 Est. Plan. 475 (Oct. 2003); Richard A Oshins & Noel Ice, "The Inheritor's Trust™: The Art of Properly Inheriting Property," 30 Est. Plan. 419 (Sept 2003); *see also generally*, Blattmachr, Gans and Lo, "A Beneficiary as Trust Owner: Decoding Section 678," 35 ACTEC Law Journal 106 (Fall 2009).

<sup>178</sup> Cf. Treas. Reg. § 20.2041-1(b)(2).

<sup>179</sup> Cases have excepted retained powers to distribute to someone other than the power holder from IRC Sections 2036(a)(2) and 2038 where the power was subject to an ascertainable standard. *Jennings v. Smith*, 161 F.

the beneficiary may be able to receive trust distributions in the discretion of an independent trustee. Such an interest will cause inclusion if the beneficiary's creditors can reach trust property under state law "creditors' rights" doctrine. Typically, creditors cannot reach trust property if the interest in the trust was conferred on the debtor-beneficiary by a third party, but can reach it if the interest was retained by the debtor or the debtor has a general power.<sup>180</sup>

(3) Who is the transferor for estate tax purposes with the \$5,000 BDIT Guaranteed Sale Technique?

It seems open to the IRS to argue that the beneficiary should be treated as the transferor for estate tax purposes of any property which the beneficiary, rather than the settlor, transfers to the BDIT, whether the beneficiary's transfer is a gift or a sale. For example, if the settlor of the BDIT transferred only one dollar to the trust and the beneficiary transferred ten million dollars by gift or sale, it seems likely that the beneficiary would be treated as the transferor of the ten million, with inclusion in the beneficiary's estate governed by IRC Sections 2036 and 2038 rather than IRC Section 2041. This result does not require applying the step transaction doctrine (although the IRS might assert that doctrine—see the discussion *supra* Section IV.A.3.e.(7)). It requires only the application of the principle that when an individual transfers property to a trust, interests in and powers over that property which the individual possesses after the transfer will be treated as retained by him, regardless of who created the trust. It seems likely that the same result would obtain if the settlor transferred only a small amount, such as \$5,000, to the trust, as is contemplated in some uses of the BDIT.

If the beneficiary's transfer is a sale rather than a gift, does the result change? First suppose that the beneficiary sells property to the trust at a bargain price equal to half the property's fair market value. It seems that such a bargain sale would make it possible for the IRS to argue that the beneficiary remains the transferor and therefore that IRC Sections 2036 and 2038 remain potentially applicable to the bargain sale. If that is so, then the IRS could make the same argument in the case of a sale for full and adequate consideration. Why should the payment of full consideration change the identity of the transferor? The proponents of the BDIT seem to maintain (though the point is not discussed explicitly) that if the sale is for full consideration, the property transferred to the trust by the beneficiary in the sale will be treated for estate tax purposes as if transferred by the trust settlor. That may be so, but for transfer tax purposes it is not clear that it is so, and the IRS may argue otherwise.

The grantor trust rules contain precise rules for determining who the transferor (grantor) is in the above examples. The beneficiary is treated as the grantor to the extent of any gratuitous

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2d 74 (2d Cir. 1949); *Estate of Budd v. Comm'r*, 49 T.C. 468 (1968), acq. 1973-2 C.B. 1; *Estate of Pardee v. Comm'r*, 49 T.C. 140 (1968); *see also Old Colony Trust Co. v. U.S.*, 423 F. 2d 601 (1st Cir. 1970); *Estate of Cutter v. Comm'r*, 62 T.C. 351 (1974). Whether the exception applies for purposes of IRC Sections 2036(a)(1) and 2038 where the retained power is exercisable in favor of the power holder under an ascertainable standard is uncertain. Logically, the exception should apply, and Action on Decision 1981-101 (Apr. 14, 1981) says that it does, but there is no developed body of law.

<sup>180</sup> See, e.g., Uniform Trust Code Section 505.

transfer to the BDIT, and in the case of a bargain sale the value in excess of the sale price is treated as a gratuitous transfer. However, the beneficiary does not become the grantor in the case of a sale at fair market value.<sup>181</sup> However, these rules may not apply for transfer tax purposes. For example, as discussed in the next paragraph, in the case of a bargain sale IRC Sections 2036 and 2038 include the entire value at death of the sold property, reduced by the consideration paid, rather than a portion of the property proportionate to the bargain element on the date of sale.

- (4) Estate tax considerations because of potential application of IRC Sections 2036 and/or 2038 with the \$5,000 BDIT guaranteed sale technique.

Unlike a conventional sale to a grantor trust in which the seller does not have a retained interest or power over the trust, under the \$5,000 BDIT Guaranteed Sale Technique, the seller is also a beneficiary of the BDIT and will have a retained interest or power, which will trigger IRC Sections 2036 or 2038, unless an exception applies. Under the “parenthetical exception” contained in both IRC Section 2036 and IRC Section 2038, these provisions do not apply “in case of a bona fide sale for an adequate and full consideration in money or money's worth.” If the exception applies, the property sold will be excluded from the beneficiary's gross estate despite the beneficiary's interests and powers under the BDIT. If the exception does not apply, the sold property is included in the beneficiary's gross estate at its date-of-death value, reduced by the consideration paid under IRC Section 2043.<sup>182</sup>

The application of the parenthetical exception under IRC Sections 2036 and 2038 requires not only that the transfer be for “full consideration,” but that it is “a bona fide sale”. In the family partnership context, courts have held that the “full consideration” and “bona fide sale” requirements are two separate tests. The courts have also held that for a transfer to be a bona fide sale the transfer of assets to the partnership must have a significant nontax investment purpose.<sup>183</sup> Whether this requirement would apply to a sale under the \$5,000 BDIT Guaranteed Sale Technique, and what it would mean in that context, are uncertain.

It seems essential that the sale be for full consideration for the BDIT to achieve its goal of keeping trust property out of the selling beneficiary's gross estate. As stated in one article: “The beneficiary must never make a gratuitous transfer to the trust.”<sup>184</sup> This puts pressure both

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<sup>181</sup> See Treas. Reg. § 1.671-2(e), especially subparagraphs (1) and (2), and Ex. (7) under subparagraph (6).

<sup>182</sup> The parenthetical exception should also apply to a sale to a self-settled trust, so it may be asked what advantage the beneficiary grantor trust provides, other than a cosmetic one. One answer may be that the “creditors' rights” doctrine will apply more strictly to a self-settled trust, although if the requirements of the parenthetical exception are met, that may not matter.

<sup>183</sup> E.g., *Estate of Strangi v. Comm'r*, 417 F.3d 468 (5<sup>th</sup> Cir. 2005); *Estate of Bongard v. Comm'r*, 124 T.C. 95 (2005).

<sup>184</sup> Richard A. Oshins, Larry Brody & Katarinna McBride, “The BDIT: A Powerful Wealth Planning Strategy When Properly Designed and Implemented,” LISI Estate Planning Newsletter 1824 (June 22, 2011), at <http://www.leimbergservices.com>.

on the valuation of the transferred property and the valuation of any note taken in return. For instance, if an appropriate court finds that for estate tax purposes the sale to the BDIT was for inadequate consideration by even a small amount, all of the then value of the BDIT at the death of the beneficiary will be included in the beneficiary's estate under IRC Sections 2036 and/or 2038, minus the value of the note (because of the operation of IRC Section 2043) at the time of the sale.

As a consequence, the beneficiary/seller should consider a defined value assignment and the filing of a gift tax return that discloses the sale. However, even if the sale is reported on a gift tax return that meets the adequate disclosure requirements of Treas. Reg. § 301.6501(c)-1(f) and the gift tax statute of limitations runs, the IRS may not be barred upon the beneficiary's death from asserting "inadequacy of consideration" for purposes of IRC Section 2036 and 2038. Adequacy of consideration is a "valuation issue" rather than a "legal issue." Treas. Reg. § 25.2504-2(c), Ex. (3). An estate tax regulation provides that for transfers after August 5, 1997, the running of the gift tax statute of limitations bars any adjustment to the value of a prior gift, and this rule "applies to adjustments involving all issues relating to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law." Treas. Reg. § 20.2001-1(b). This regulation, applies "[f]or purposes of determining the amount of adjusted taxable gifts as defined in IRC Section 2001(b)." Furthermore, determining inclusion under IRC Sections 2036 and 2038 is not the same as determining the amount of adjusted taxable gifts and the regulation may not prevent revisiting the consideration question under IRC Sections 2036 and 2038. The gift tax disclosure regulations do not specifically address finality on the issue of adequate consideration for purposes of IRC Sections 2036 or 2038. They do address the case of an incomplete transfer reported as a completed transfer. Treas. Reg. § 301.6501(c)-1(f) provides that "if an incomplete gift is reported as a completed gift on the gift tax return and is adequately disclosed, the period for assessment of the gift tax will begin to run when the return is filed, as determined under IRC Section 6501(b). Further, once the period of assessment for gift tax expires, the transfer will be subject to inclusion in the donor's gross estate for estate tax purposes only to the extent that a completed gift would be so included." The final sentence is ambiguous as applied to an attempt to invoke IRC Sections 2036 and 2038 at death on the grounds that the transfer was not for full consideration, but the more convincing reading is that the regulation would not preclude inclusion of the transfer under those sections, because IRC Sections 2036 and 2038 can apply to transfers which are completed gifts. Moreover, it is not clear that the regulation, which applies when "an incomplete gift is reported as a completed gift," will apply to a return that reports the transfer as a sale for full consideration but says nothing about whether any value later determined to be in excess of the consideration is a complete or incomplete gift. That is the way most such gift tax returns will read, because the beneficiary typically will want to preserve the "incompleteness" argument as to any gift if the consideration is found inadequate.

Additionally, the gift tax return filing will not start the statute of limitations running on an estate tax issue of whether the sale is a "bona fide sale" because that is a legal issue, which may only be determined on the taxpayer's death. This may put pressure on the non-tax purpose of the sale. Like any sale, the non-tax purpose may be met if the taxpayer can demonstrate that there was a plausible risk/reward commercial relationship with respect to the sale and, in that regard, there was adequate security to demonstrate that the note had the characteristics of a note and not a deemed retained interest in the trust. Hopefully, on the taxpayer's death, it can be

demonstrated that there was a high probability that the note would be paid in full, and, in fact, it was paid in full.

(5) Estate tax considerations if under applicable state law or federal bankruptcy law the seller/beneficiary's creditors can reach the BDIT assets under the \$5,000 BDIT guaranteed sale technique.

Even if an assigning seller/beneficiary does not have any current creditors, or any future creditors, if the assigning seller/beneficiary could create a creditor relationship under which part or all of the trust assets, either under state law or federal bankruptcy law, would be available to satisfy that creditor obligation, that part or all of the trust will be included in the assigning seller/beneficiary's estate for estate tax purposes. Even if the sale is for adequate and full consideration for gift tax purposes, the IRS could take the position that either (i) the sale is not adequate for creditor protection purposes under the relevant state property law or (ii) even if the sale is adequate for state law purposes, the assigning seller/beneficiary, under certain assumptions, could still create a future creditor relationship that could access the trust.

(6) If it is possible for a current or future creditor of an assigning seller/beneficiary to reach that part of the trust assets that are sold, then that part of the trust may not constitute a complete gift for gift tax purposes.

The IRS could argue that because of state property law, or federal bankruptcy law, the grantor/beneficiary could create a future creditor relationship, which would terminate part or all of the trust. That power by the assigning seller/beneficiary would mean that the assigning seller/beneficiary has retained dominion and control over that part of the trust, and has not completed a gift for gift tax purposes under Treas. Reg. § 25.2511-2(b).<sup>185</sup>

c. Income tax considerations with the \$5,000 BDIT guaranteed sale technique.

(1) In general.

The BDIT must remain a grantor trust during the beneficiary's life, or at least while any note is outstanding, in order to circumvent a capital gain on the sale (or as installments are paid), income tax on interest payments, and (possibly) adverse consequences upon loss of grantor trust status under Treas. Reg. § 1.1001-2(c), Ex. (5). To achieve grantor trust status under IRC Section 678, initially the beneficiary must have over the trust "a power exercisable solely by himself to vest the corpus or the income therefrom in himself." IRC Section 678(a)(1). If left in place, such a power would cause the trust property to be includable in the beneficiary's gross estate under IRC Sections 2036 and 2038, or under IRC Section 2041, whichever is viewed as

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<sup>185</sup> See *Outwin v. Comm'r*, 76 TC 153 (1981), acq. 1981-2 CB 1; *Herzog v. Comm'r*, 116 F.2d 591 (2d Cir. 1941).

applicable. Thus, this power must be cut down before the beneficiary's death without either (1) losing grantor trust status, or (2) causing the beneficiary to be treated as the transferor for estate tax purposes.

Once the beneficiary acquires a power described in IRC Section 678(a)(1), IRC Section 678(a)(2) provides that the trust continues to be a grantor trust after the power holder "has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of IRC Sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof."

- (2) It is necessary for the settlor of the BDIT to steer clear of grantor trust status.

In order to achieve grantor trust status for the beneficiary of the BDIT under IRC Section 678, the trust cannot be a grantor trust to the settlor. In Private Letter Ruling 200949012, the IRS rules that the trust would not be a grantor trust as to the settlor, yet the beneficiary would be treated as the owner for income tax purposes under IRC Section 678. The design of the trust in that private letter ruling provides a great roadmap in avoiding grantor trust status for the settlor. The private letter ruling notes the following key facts:

"Grantor is not a beneficiary under the Trust, and has no interest under the Trust. Trust provides that no income or principal of Trust may be paid or appointed for the benefit of the Grantor or Grantor's spouse, or to pay premiums on insurance policies on the life of Grantor and/or Grantor's spouse. Trust further provides that neither Grantor nor Grantor's spouse may act as a Trustee of Trust and that no more than one-half of Trustees of Trust may be related or subordinate parties to Grantor, within the meaning of § 672(c).

Trust further provides that Grantor does not intend to be treated under subpart E of Part I of subchapter J as the owner of Trust. Trust further provides that neither Grantor nor any other "non-adverse party" as that term is defined in § 672(b) shall have the power to (1) purchase, exchange or otherwise deal with or dispose of Trust's principal or income for less than adequate consideration or (2) borrow any of Trust's principal or income without adequate interest or security. Trust further provides that no person, other than a United States person, shall have the authority to control any substantial decision (within the meaning of § 7701(a)(30)(E) of any trust created under an [sic] held under Trust. No court, other than a court within the United States, shall exercise primary supervision over the administration of any trust created and held under Trust. Grantor and beneficiary represent that Trust will be a domestic trust within the meaning of § 301.7701-7 of the Procedure and Administration Regulations."

The private letter ruling concludes that based on the above facts the settlor will not be taxed under the grantor trust rules.

## (3) Release vs. lapse.

One issue with respect to any BDIT in which there is a lapse of a withdrawal right, is whether IRC Section 678(a)(2) applies when the power is cut down by a lapse rather than a release. If a lapse occurs pursuant to the terms of the trust, can the power holder be said to have “partially released or otherwise modified” the power? In two non-precedential private rulings issued in 2009 and 2010, the IRS has held that after a lapse the beneficiary continues to be taxable on the income of the trust under IRC Section 678(a)(2).<sup>186</sup> These are the latest in a long line of private rulings that treat a lapse as covered by the “partially released or otherwise modified” language of IRC Section 678(a)(2).<sup>187</sup> However, the rulings do not discuss in detail the issues underlying that result. Some worry that the rulings are questionable and the IRS could change its position because a lapse is different than a release, and IRC Section 678(2) does not mention lapses.<sup>188</sup> A “release” requires an act by the power holder, while a “lapse” can occur pursuant to the terms of the trust without an affirmative act. Is a lapse a release or other modification as required by IRC Section 678(a)(2)? The private rulings imply that the answer is yes.<sup>189</sup>

## (4) Partial release or other modification.

Assuming a lapse can qualify as a release or other modification, the next issue with respect to any BDIT in which there is a lapse of a withdrawal right is whether a power that has lapsed completely (either all at once or in stages over time) remains one described in IRC Section 678(a)(2), given the statute’s requirement that the IRC Section 678(a)(1) power have been “partially released or otherwise modified” (underscoring added). For estate tax purposes, it would be desirable to eliminate the power of withdrawal entirely prior to death because, even if tested under IRC Section 2041, it is a general power. In PLR 201039010 withdrawal powers over successive additions lapsed completely (within the “5 & 5” limits) after each year’s addition, but IRC Section 678(a)(2) was held to apply, without discussion of the word “partially” in the statute. One way to read IRC Section 678(a)(2) is that if the beneficiary once had an IRC Section 678(a)(1) power, IRC Section 678(a)(2) applies as long as the beneficiary has any continuing interest or power that would make a self-settled trust a grantor trust, even if the beneficiary no longer has any power to withdraw. The line of private rulings mentioned in the preceding paragraph supports this reading. The language of the pertinent Regulation seems also to support it.<sup>190</sup> This reading is not certain, however, and some practitioners would argue that

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<sup>186</sup> See PLR 200949012 (Aug. 17, 2009); PLR 201039010 (June 29, 2010).

<sup>187</sup> See rulings cited in Howard Zaritsky, “*The Year in Review: An Estate Planner’s Perspective on Recent Tax Developments*,” TM Estates Gifts and Trusts Journal (BNA) (Jan. 13, 2011).

<sup>188</sup> See Kestenbaum, Galant, and Akhavan, “The Beneficiary Defective Inheritor’s Trust: Is It Really Defective?” LISI Estate Planning Newsletter 1730 (Dec. 14, 2010), at <http://www.leimbergservices.com>.

<sup>189</sup> Under the gift and estate tax, specific statutes provide that a lapse is a release. IRC Sections 2514(e), 2041(b)(2). These provisions do not apply to the extent the lapsed power covered less than the greater of \$5,000 or 5% of the trust’s value.

<sup>190</sup> Treas. Reg. § 1.678(a)-1(a) states: “The holder of [an IRC Section 678(a)(1) power] also is treated as an owner of the trust even though he has partially released or otherwise modified the power so that he can no longer

the power to withdraw must continue to some extent for the lapse to be “partial.”<sup>191</sup> The design of the trust described in PLR 200949012 fineses this issue, giving the beneficiary a continuing withdrawal power under an ascertainable standard, supporting the conclusion that there has been a “partial release” or other “modification” of the unlimited withdrawal power, rather than a complete release. Again, however, the ruling does not discuss the issue specifically.

D. Alternative to the \$5,000 BDIT Guaranteed Sale Technique: A Substantially Funded BDIT Created by a Hanging Power Lapses in Another Substantially Funded BDIT.

1. What is the substantial lapsing hanging power created BDIT?

The settlor to a BDIT (“BDIT 1”) could contribute a corpus that is much greater than \$5,000. The BDIT 1 could be designed so that the original unlimited power to withdraw all of the assets of the trust gradually lapses over time pursuant to a so-called “hanging power.” The trust assets with that unlimited power to withdraw could pass to another trust (“BDIT 2”) in which the beneficiary only has the power to withdraw pursuant to an ascertainable standard. The technique may be illustrated by the example below:

*Example 19: A BDIT is Created By a Third Party With Substantial Assets and Under Which There is Only a Gradual Lapse of the Unlimited Withdrawal Power*

*Wilhelmina Withdrawal creates a trust, BDIT 1, for the benefit of her son Wiley Withdrawal. She contributes \$1,000,000 to the trust. Wiley has an unlimited power of withdrawal of \$1,000,000 for any reason, which gradually lapses over time (this lapsing power annually lapses by the greater of 5% of the value of the assets or \$5,000.00). Each year when the unlimited power to withdraw \$1,000,000 partially lapses, the trust assets equal to that lapse are held in another trust, BDIT 2, in which Wiley Withdrawal has a direct or indirect limited power of withdrawal that never lapses and that limited power of withdrawal is tied to an ascertainable standard relating to Wiley’s health, support and maintenance. Wiley lives in a state where his creditors cannot reach the assets of a trust that is not included in his estate under IRC Section 2041 despite his powers of withdrawal.*

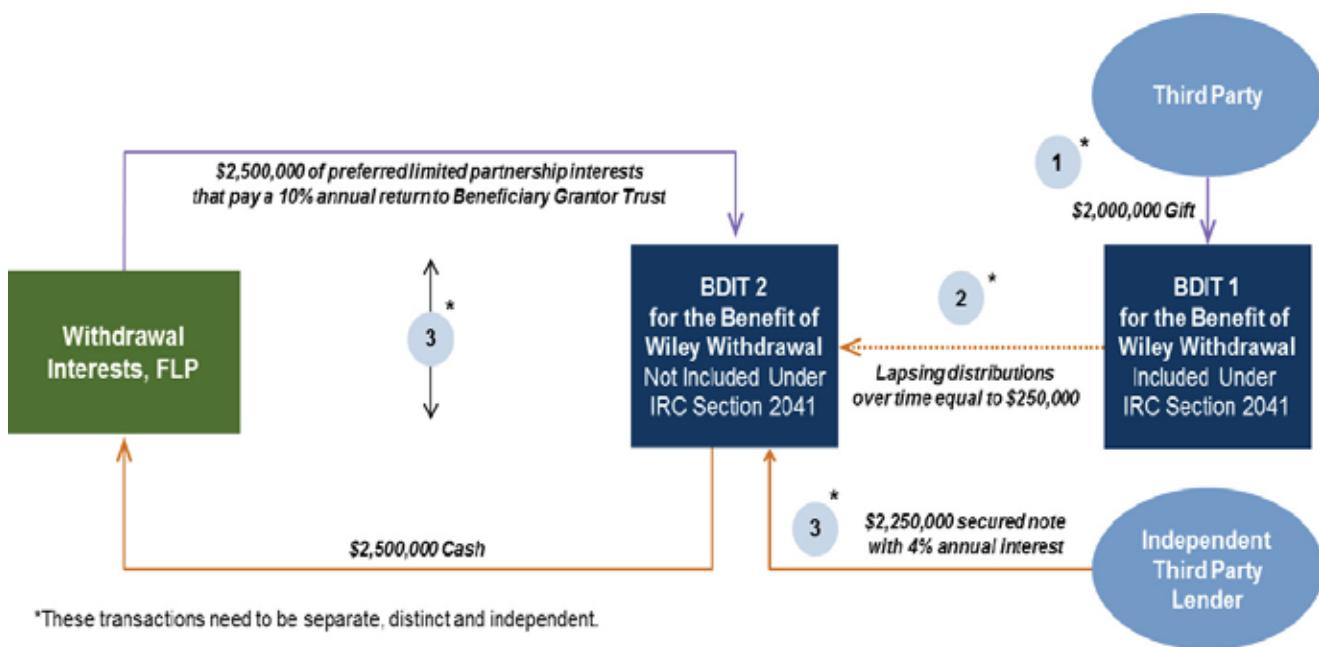
*Five years later, the trust in which Wiley has a limited power of withdrawal (BDIT 2) has \$250,000 in it. That trust then borrows \$2,250,000 from an independent third party and invests \$2,500,000 in Withdrawal Interests, FLP and receives a preferred limited partnership interest that pays a 10% coupon and has certain put rights.*

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vest the corpus or income in himself, if he has retained such control of the trust as would, if retained by a grantor, subject the grantor to treatment as the owner under IRC Sections 671 to 677, inclusive.” See Galant, “Beneficiary Grantor Trusts: Overview of Selected Issues,” paper prepared for the ACTEC Business Planning Committee Summer 2011 Meeting.

<sup>191</sup> Blattmachr and Zeydel, “PLR 200449012 – Beneficiary Defective Trust(sm) Private Letter Ruling,” LISI Estate Planning Newsletter 1559 (Dec. 10, 2009), at <http://www.leimbergservices.com>.

This technique is illustrated below:



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

2. Additional advantages of the substantial lapsing hanging power created BDIT technique.

The use of a reverse freeze (using high yielding preferred partnerships) has been explored by this writer and others.<sup>192</sup> A high yielding preferred partnership interest may make excellent collateral to an independent third-party lender. Assuming the trust is not taxable in Wiley's estate, any future sales into the trust in which Wiley has a limited power of withdrawal should not be subject to capital gains taxes. The trust, as described above, would have considerable flexibility for Wiley's cash flow needs. Assuming Wiley has a limited power of appointment over the trust he should be able to reallocate the corpus of the trust if he has different stewardship goals at the time of his death. In the initial year, the trust has \$250,000 in free cash flow to pay to the third-party lender.

Over time, as the note is paid down, and also over time as more assets are available to the trustee because of future lapsing distributions to BDIT 2, greater equity will exist in the trust. This equity could support subordinated note sales of other assets (e.g., preferred partnership interests) by Wiley Withdrawal. All of this could be done without the necessity of guarantee fees or sales of remainder interests in GRATs. There is much more substance to the leverage of this technique than the techniques discussed in Examples 14 and 20. Furthermore the leverage is coming from an independent third-party lender instead of the transferor/beneficiary of the BDIT.

<sup>192</sup> See this author's paper, "Some of the Best Family Limited Partnership Ideas We See Out There," ALI-ABA Planning Techniques for Large Estates, at 167-82 (Nov. 5, 2010); see also the discussion in Section III.D. and E.

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3. Considerations of the substantial lapsing hanging power created BDIT technique.
  - a. Use of a BDIT raises many of the income tax issues discussed previously.
  - b. IRC Section 2041 issues.

If the beneficiary should die in the early years of the trust, a substantial portion of the original trust, which is subject to IRC Section 2041, will be included in his estate because of the unlimited power to withdraw assets to the extent the unlimited power to withdraw assets is still in existence.

- c. Use of a third-party lender.

This technique may also require the existence of an asset that is attractive as security to a third-party lender, because a third party will demand collateral that has substantial inherent cash flow and safety. A high yielding preferred partnership interest, in which the other assets of the partnership are subordinated to the preferred partnership interest, may be such an asset.

- d. Pecuniary withdrawal right issues.

This use of the BDIT, in which there is a lapse of a withdrawal right, calls for the settlor to contribute to the trust property with a value greater than \$5,000, so that the beneficiary's power of withdrawal cannot lapse in full at the end of the first year and must lapse over time as a "hanging power".<sup>193</sup> Assuming the trust appreciates in value, the power may lapse faster if it is defined as a pecuniary amount, because the appreciation will increase the potential annual lapse without increasing the amount withdrawable under the power. However, this raises another IRC Section 678 consideration: whether the trust could lose its status as a wholly grantor trust in a year in which, because of appreciation in the value of the trust, the pecuniary amount withdrawable under IRC Section 678(a)(1), plus the portion of the trust subject to IRC Section 678(a)(2) by reason of prior lapses, totals less than the current value of the trust. Under Treas. Reg. § 1.671-3(a)(3), the IRS could also argue that the portion of the trust represented by such excess appreciation is not currently subject to the grantor trust rules, so the BDIT is no longer wholly a grantor trust. Moreover, in the absence of subsequent depreciation, it seems that the portion not subject to IRC Section 678(a)(1) can never become subject to IRC Section 678(a)(2), so that the trust never again becomes wholly grantor, although some argue otherwise.<sup>194</sup>

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<sup>193</sup> The annual lapse of the power of withdrawal will be limited to the greater of \$5,000 or 5% of the value of the trust, to keep the Beneficiary from being treated under IRC Section 2041 as a transferor for gift and estate tax purposes by reason of the lapse. As mentioned above, this requires that the governing law must protect such a lapse from creditors' rights, which is the case under Uniform Trust Code Section 505(b)(2).

<sup>194</sup> Blattmachr and Zeydel, "PLR 200449012 – Beneficiary Defective Trust(sm) Private Letter Ruling," LISI Estate Planning Newsletter 1559 (Dec. 10, 2009), at <http://www.leimbergservices.com>.

For example, if the trust assets initially covered by the withdrawal power is X where X equals the entire value of the trust, but in a future year the trust is worth 4X, the portion of the trust considered to be a grantor trust under IRC Section 678 in that year may be 25%. Moreover, if the power then lapses each year to the extent of 5% of the value of the trust per year, assuming no further appreciation or depreciation, the maximum portion of the trust that will eventually consist of property over which a power of withdrawal lapsed will also be 25%, and the trust never again becomes wholly grantor. Obviously, if that is the correct interpretation, the servicing of any note from a sale by a beneficiary to the trust would be disadvantageous to the extent a trust is treated as a complex trust instead of a grantor trust. The IRS has never taken this approach in its private letter rulings regarding trusts that qualify to be Subchapter S shareholders because they are grantor trusts.<sup>195</sup> Otherwise, if the trusts were not wholly grantor trusts, they might not have qualified as Subchapter S trusts.

One solution to the problem discussed in the preceding paragraphs may be to initially define the beneficiary's withdrawal right as extending not to a pecuniary amount but to 100% of the trust property, lapsing each year as to 5% of the trust (or such greater percentage as equals \$5,000 in value). This will require more time for the power to lapse completely.

It should be noted that some practitioners believe that the "portion" rule of Treas. Reg. § 1.671-3(a)(3) does not apply when the beneficiary's pecuniary power of withdrawal is large enough to make all property added to the trust withdrawable, even if subsequent appreciation or income accumulation increases the trust's value above the pecuniary amount. In such a case, all value in the trust is attributable to property over which the beneficiary once had a power of withdrawal. The beneficiary could have captured all the increasing value for himself by promptly exercising the power, but instead allowed it to "lapse" as to such value. Therefore, it can be argued that any value that is no longer withdrawable is covered, at least in a policy sense, by IRC Section 678(a)(2).<sup>196</sup>

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<sup>195</sup> For example, *see* PLR 200011058 (Dec. 15, 1999); PLR 200011054 to 056 (Dec. 15, 1999); PLR 199942037 (June 7, 1999); PLR 199935046 (June 7, 1999).

<sup>196</sup> Gorin, "Beneficiary Grantor Trusts: A New Paradigm for Transferring Businesses," paper prepared for the ACTEC Business Planning Committee Summer 2011 Meeting, pp. 14-15; *see also* "Beneficiary Grantor Trusts: Overview of Selected Issues," paper prepared for the ACTEC Business Planning Committee Summer 2011 Meeting, section A(2).

E. Alternative to the BDIT Guaranteed Sale Technique and the Substantial Hanging Power Created BDIT: The Technique of a \$5,000 BDIT Jointly Creating a GRAT or a LAGRAT with the BDIT Providing the Consideration for the Remainder Interest (the “BDIT Remainder Purchase”) Technique.

1. What is the BDIT remainder purchase technique?

A third party could create a BDIT for the benefit of a transferor who is contemplating creating a GRAT or a LAGRAT.<sup>197</sup> The BDIT could be designed so that the third-party settlor is not taxable on the BDIT income under the grantor trust rules. The BDIT could also be designed so that the beneficiary has an unlimited right to withdraw of all of the assets that are in the BDIT for a period of time. The right of withdrawal lapses after a period of time, (e.g., one year) in an amount equal to the greater of 5% of the value of the corpus of the BDIT or \$5,000. However, the beneficiary could also be given the direct or indirect right to continue to withdraw income and principal of the assets of the BDIT, as long as it is for the beneficiary’s health, education, support or maintenance as described under IRC Section 2041. The situs of the BDIT is in a jurisdiction in which a lapse of the greater of 5% of the corpus or \$5,000 does not give a creditor rights to the BDIT. The beneficiary/transferor could jointly create a GRAT or a LAGRAT with the BDIT in which the BDIT trustee pays for the remainder interest (which is the technique explored below). The beneficiary/transferor is considered the owner of the BDIT for income tax purposes under IRC Section 678.

Consider the following example:

*Example 20: Contribution of an Equity Interest in a Leveraged Limited Liability Company to a Jointly Created GRAT in Which the BDIT Remainderman Pays Full Consideration for That Remainder Interest*

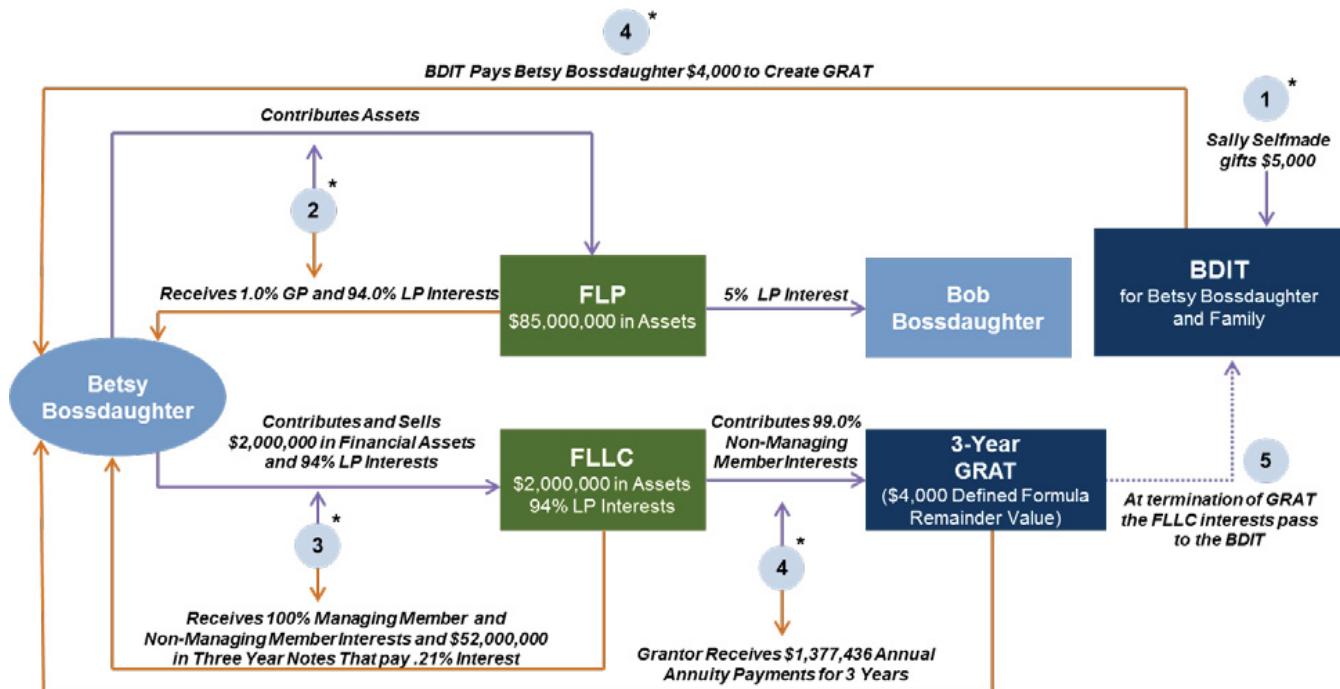
*Betsy Bossdaughter has \$97,000,000 in financial and private equity assets. Betsy wishes to maintain maximum flexibility in her estate planning. Betsy also wishes to retain the right to change her mind as to future stewardship goals and consumption needs. Betsy’s husband, Bob owns \$5,000,000 in assets. Assume that Betsy and Bob’s assets will grow at 7.4% a year pre-tax. Betsy’s mother, Sally Selfmade, is still living. Sally is going to create a generation-skipping trust for the benefit of Betsy. The trust will have a corpus of \$5,000 (Transaction 1 below). The trust agreement will provide that Betsy has the right to withdraw all the trust assets for a year. That right lapses after a year. After the first year, Betsy will also have the power to withdraw the trust assets as needed for her health, support and maintenance in order to maintain her standard of living. That right will not lapse. In a separate and distinct transaction, after Sally creates the \$5,000 trust, the trustee of the trust transfers \$4,000 of the trust to Betsy for full consideration for Betsy creating a GRAT, with the assets described below, that has a \$4,000 defined value remainder interest (Transaction 4 below).*

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<sup>197</sup> The LAGRAT technique is a GRAT created in compliance with the rules of IRC Section 2702 in which the grantor of the GRAT contributes an interest in a very leveraged asset (e.g., a leveraged single-member LLC) to the GRAT.

The GRAT is funded with non-managing member interests in a FLLC that was funded with limited partnership interests in a FLP, as illustrated below (Transactions 2 and 3 below). It is assumed that valuation discounts for transfers of the limited partnership interests and the non-managing member interests of the FLLC are each equal to 30%. It is assumed that the IRC Section 7520 rate is 1.0%.

This technique is illustrated below:



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

## 2. Advantages of the BDIT remainder purchase technique.

- The assets of the BDIT, if the transferor is not a deemed donor under equitable principles, will not be subject to estate taxes in the transferor's estate.

Under the assumed facts, if Betsy is not a transferor, or a deemed transferor under equitable principles, the BDIT assets may not be taxable in the beneficiary's estate. See the discussion *supra* Section VI.C.2. The lapsed withdrawal power meets the exception of IRC Section 2041.

Obviously, if this technique is successful, it could be a very powerful technique with respect to estate planning for Betsy Bossdaughter and her family. Please see the table below and attached Schedule 14, which denotes what the estate taxes would be at the end of five years, 15 years and 30 years:

Table 15

| Hypothetical Results   | Assuming Mr. and Mrs.<br>Bossdaughter<br>Die at the End of 5 Years | Assuming Mr. and Mrs.<br>Bossdaughter<br>Die at the End of 15 Years | Assuming Mr. and Mrs.<br>Bossdaughter<br>Die at the End of 30 Years |
|--|--|---|---|
| <b>Estate Taxes at 40%</b>   |  |   |   |
| No Further Planning; Bequeaths Estate to Family (assumes \$25.5mm estate tax exemption available)  | \$44,243,250   | \$61,859,403  | \$102,572,795   |
| Third Party Gift to a Trust in Which the Beneficiary is Taxed Under 678 but not Taxable in the Beneficiary's Estate (678 Trust); Creation of a Single Member FLLC with Contribution of Non-Managing Member Interests to a 3-Year GRAT in Which There is No Gift Because of a Purchase by the 678 Trust; the GRAT Remaindermen is a 678 Trust Created for the Benefit of the Grantor and His Family; Bequeaths Estate to Family (assumes \$25.5mm exemption is available) | \$23,651,853   | \$16,164,598  | \$0   |

- b. Avoids capital gains tax consequences on the sale of assets to the trust.

There should not be any capital gains consequences on creation of a leveraged FLLC. *See* discussion *supra* Section IV.A.3. There also should not be any capital gains consequences on the creation of the GRAT by contributing the FLLC interests to the GRAT. The GRAT can be designed to be a grantor trust to the grantor. The creation of the grantor retained annuity trust in consideration for the cash coming from a BDIT in which a grantor is taxed under IRC Section 678 should also be income tax free, since both trusts are treated as grantor trusts.

- c. Has the advantage of allowing Betsy access to cash flow from note payments, and as a beneficiary of the BDIT.

If the transaction is successful, during the term of the GRAT, the grantor of the GRAT will have access to the cash flow of the assets of the FLLC, either through the note payments from the FLLC, or the annuity payments from the GRAT. After the GRAT terminates, the transferor will have access to the cash flow of the assets of the FLLC either from the note payments of the FLLC, or under the terms of the BDIT, if the cash flow of the BDIT is needed for her support and maintenance.

- d. The transferor has flexibility to change the future beneficiaries of the trust through the exercise of a special power of appointment.

If the transferor has a power of appointment over the BDIT the taxpayer also has the flexibility of redirecting the assets in a manner that may be different than the default provisions of the trust document.

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- e. Has the potential to avoid gift tax surprises.

The GRAT can be designed with a built-in revaluation clause. If the IRS disputes any valuation discounts associated with the FLLC, because of the built-in revaluation clause the annuity amounts accruing back to the taxpayer would increase. Such a clause should not be against public policy and, in fact, is explicitly permitted by the IRS regulations. Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

- f. Appreciation will be out of the transferor's estate.

To the extent the assets of the FLLC increase in value above the interest carry on the note and the annuity payments that accrued back to the transferor, that appreciation should be out of the transferor's estate, assuming the transaction is recognized for estate and gift tax purposes.

### 3. Considerations of the BDIT remainder purchase technique.

- a. In order for the full and adequate consideration exception under IRC Section 2036 to apply, the remainder interest of the GRAT that is sold may need to have a substantive value much greater than \$4,000.

There are three Circuit court cases<sup>198</sup> providing that IRC Section 2036 does not apply when there has been full and adequate consideration for a sale of a remainder interest in a trust. However, in each of those case there was a substantial remainder interest (much greater than \$4,000). Query: would the courts be reluctant to provide that adequate and full consideration exists to circumvent application of IRC Section 2036 in a situation in which only \$4,000 is paid in the context of a multi-million-dollar trust? Stated differently, with the significant leverage involved in the creation of a FLLC, and the significant leverage involved in creating a GRAT, would a court take the view that the leverage is too extreme and that the substance of the transaction is a transfer of the FLLC interests by the beneficiary/transferor to the BDIT for less than full consideration? A court could take the position that those cited cases are all distinguishable because the purchase of the remainder interest in each of those cases had economic risk for the purchaser of the remainder interest. Under the Sam and Sally facts, the economic exposure of the BDIT resulting from its purchase of the GRAT remainder is \$4,000. In the context of a multi-million-dollar GRAT, a court may conclude that the remainderman trust's (i.e., the BDIT's) economic risk in the transaction lacks substance in comparison to the potential reward. In *Strangi*, the full Tax Court and the Fifth Circuit both concluded that IRC Section 2036 applies to any and all transfers, even if gift taxes are not owed on that transfer by that transferor.<sup>199</sup> If the remainder trust purchase had substance IRC Section 2036 should not apply. But a court may find that is not the case under facts similar to Example 20. If the purchase

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<sup>198</sup> See *Estate of D'Ambrosio v. Comm'r*, 101 F.3d 309 (3rd Cir. 1996); *Wheeler v. U.S.*, 116 F.3d 749 (5th Cir. 1997); *Estate of Magnin v. Comm'r*, 183 F.3d 1074 (9th Cir. 1999); contra, *Gradow v. U.S.*, 11 Cl. Ct. 808 (1987), aff'd, 897 F.2d 516 (Fed. Cir. 1990).

<sup>199</sup> See *Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000), aff'd, 417 F.3d 468 (5<sup>th</sup> Cir. 2005).

of the remainder is not a “bona fide sale for an adequate and full consideration” IRC Section 2036 and/or 2038 could apply. The GRAT formula clause, unless easy to value assets are used or the GRAT and the BDIT have proportionate interests in the same entity, does not ensure that the consideration paid will equal the value of the remainder interest if values are increased on audit, because the remainder will increase proportionally and exceed the original payment. It may be possible to solve this problem by having the BDIT “overpay” for the remainder, which the trustee would have a rational reason to do to insure against later depletion of the trust assets by the beneficiary’s estate tax apportioned to the trust, or by using a defined value clause for the sale, with any remainder value in excess of the sale price passing by gift to a recipient other than the BDIT.

- b. This technique could also be utilized with a BDOT jointly created GRAT with the BDOT, or Spousal Grantor Trust, providing the consideration for the remainder interest.

The above consideration of a BDIT not having enough substantive value in order to avoid IRC Section 2036 may not be present with a BDOT, or a Spousal Grantor Trust, if it has substantial value. The BDOT, or Spousal Grantor Trust, could be designed to be a generation-skipping trust.

- c. Need to file a federal gift tax return.

A federal gift tax return needs to be filed in order to determine if there should be any adjustments with the GRAT and to get the statute of limitations running. There will be an expense in connection with filing the federal gift tax return and with the necessary appraisals attendant with the technique.

- d. State income tax considerations.

There may be state income tax considerations on the sale of any appreciated assets to the FLLC. There also may be state income tax consequences in selling the remainder interest of a GRAT to the BDIT.

- e. Step transaction doctrine could apply.

If the IRS can demonstrate, because of the thin capitalization, the \$4,000 payment should be ignored, then under other equitable principles it may be able to establish the creation of the BDIT lacks independence, and the deemed grantor of the trust will be the beneficiary.

- f. Creditor rights and related estate tax issues.

If the sale to a FLLC and the creation of the GRAT with the FLLC interests in consideration for a \$4,000 payment from the BDIT is not for adequate and full consideration, then under the laws of the state of the beneficiary, the creditors may be able to reach whatever interest the beneficiary of the trust could distribute to himself or herself, and whatever the trustee could distribute to the beneficiary. A settlor’s ability to redirect to creditors may include that portion of the trust in the beneficiary’s estate under either IRC Section 2036 or IRC Section

2038. The lapse of a power over not more than the greater of 5% or \$5,000 does not cause the power holder to be treated as a settlor of the property subject to the lapse under the laws of many states.<sup>200</sup> Here, however, the beneficiary's transfer of the remainder interest to the trust may make him a settlor for creditors' rights purposes despite those statutes, as his continuing interests and powers in the BDIT arguably result from the beneficiary's own transfer, rather than from the lapse of his unlimited power of withdrawal.

g. Incomplete gift issues.

F. Freeze Planning with Subchapter S Stock and a Qualified Subchapter S Trust  
(*Also See Supra* Section III.C. for a Discussion of Using a QSST to Lower the Tax of a Complex Trust).

1. What is the technique?

A third party could create a trust for the benefit of a potential transferor to the trust, which would meet the requirements of a qualified subchapter S trust (QSST) under IRC Section 1361(d). The potential transferor could create, or may have already created, a subchapter S corporation to hold his investment assets and/or trade or business. The transferor could then sell his voting and/or nonvoting stock that he has in the subchapter S corporation to the QSST that has been created by a third party. It is important that the sale be in consideration of a secured note in which the security is the transferred stock and all distributions on that stock.

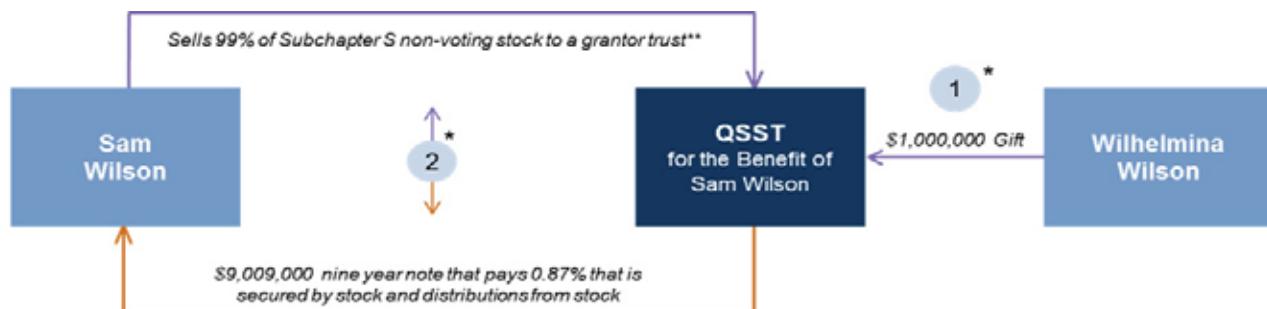
*Example 21: A Third Party Creates a QSST For the Benefit of a Transferor and Then the Transferor Sells, For a Secured Note, the Transferor's Non-Voting Stock in a Subchapter S Corporation to the Qualified Subchapter S Corporation to the Trust*

*Sam and Sally Wilson own \$20,000,000 in financial assets. Sam also owns a subchapter S corporation that has \$13,000,000 of business assets, which primarily constitutes private equity investments that have a relatively low basis (\$2,000,000). His mother, Wilhelmina Wilson contributes \$1,000,000 to a dynasty trust that could qualify to be a QSST. Sam, as the income beneficiary of the trust, has a right to principle distributions of the trust for his support and maintenance. Sam also has a limited testamentary power of appointment to appoint the trust assets to his family and/or Sally. Sam sells his nonvoting stock (which represents 99% of the capitalization of the subchapter S corporation) to the QSST in exchange for a secured note. The security for the note is the stock that is sold and the distributions from that stock. It is assumed that the estimated pre-tax rate of return of the subchapter S corporation will average 12% a year. It is also assumed that the rate of return on the remaining financial assets of Sam and Sally will average 7.0% a year pre-tax. It is assumed that Sam and Sally will consume \$250,000 a year as adjusted for inflation.*

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<sup>200</sup> See Uniform Trust Code Section 505(b)(1) and the comments under it.

This technique is illustrated below:



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

\*\* It is assumed there is a 30% discount and the Subchapter S assets are worth \$13,000,000.

a. IRC Section 678 ownership of S corporation stock by beneficiary.

Under IRC Section 1361(d)(1)(B) the transferor (as a beneficiary of the QSST) will be treated as the owner of the subchapter S stock held in trust under IRC Section 678(a).

b. What is a QSST?

A QSST is a trust that has only one income beneficiary and any corpus distributed during the life of the current beneficiary may only be distributed to that beneficiary. After an election is made by the beneficiary, the beneficiary is taxable on the taxable income of any subchapter S stock that is owned by the trust as if the trust is a grantor trust to the beneficiary under IRC Section 678(a).

c. Disregarded sales of stock to a QSST.

Under IRC Section 678(a) the trust is ignored for income tax purposes, at least with respect to any subchapter S stock that is held in the trust. It should be noted that the trust assets other than the subchapter S stock will be taxed under the normal subchapter J rules. Thus, the sale of subchapter S corporation stock should not trigger any capital gains consequences to the transferor, if he sells to a trust that qualified as a QSST,<sup>201</sup> because the seller is considered the

<sup>201</sup> See Rev. Rul. 85-13, 1985-1 C.B. 184 and the authorities discussed therein. This Revenue Ruling involved the sale to a trust that was not a grantor trust before the sale. However, because of the terms of the sale, the trust became a grantor trust and the seller was considered the owner of the sold trust property both before and after the sale. The same analysis would appear to apply for a sale, of subchapter S stock by a subchapter S owner to a QSST held for his benefit, even if the QSST was not a grantor trust under IRC Section 678 until the sale. The seller of the subchapter S stock to a QSST, held for the benefit of the seller, should be considered the income tax owner of the sold subchapter S stock both before and after the sale. Thus, no capital gains consequences should arise. However, Rev. Rul. 85-13 involved an activity with a trust that was disregarded for income tax purposes because of IRC Sections 671-677, not IRC Section 678. If that is a concern, the sale could be to a single-member LLC that is owned by the QSST. See the discussion above. To minimize the risk, the trust should be treated as owned by the beneficiary prior to the sale. This can be achieved if the trust holds a small amount of stock and a QSST election is made prior to the sale of additional stock by the beneficiary.

owner of the stock both before and after the sale for income tax purposes. A QSST, while it owns subchapter S stock, may have only one beneficiary (who also must be a U.S. citizen or resident), all of its trust accounting income<sup>202</sup> must be distributed to that beneficiary. The beneficiary may receive corpus during the beneficiary's lifetime. The beneficiary must elect to be taxable on the income of the QSST.<sup>203</sup> The beneficiary may have a testamentary power of appointment.

Can the distributions from the subchapter S corporation stock owned by the QSST, which are collateral on the transferor's note, be used to retire both the principal and interest of the note on which the QSST is the obligor? Clearly interest on a note is a charge against the income of a trust for trust accounting purposes and should be paid by the trustee of the QSST. *See* Section 501(3) of the Uniform Principal and Income Act. The distributions on the purchased subchapter S stock to the QSST can also be used by the trustee of the QSST to retire the principal on the note, if the distributions are security for a note on which the QSST is the obligor. Compare the interaction of Sections 502(b) and 504(b)(4) of the Uniform Principal and Income Act. There may need to be an equitable adjustment between the principal and income of the trust when the distributions from purchased subchapter S stock are used by the trustee of the QSST to retire principal of the debt used for that purchase, depending upon the interaction of Sections 502(b) and 504(b)(4) of the Uniform Principal and Income Act. The fact that subchapter S distributions are part of the security for the debt, and are used to retire the principal of the debt, does not disqualify the trust from being a QSST.<sup>204</sup>

2. Advantages of the technique.

- a. A QSST can be substantively funded, which may be more advantageous than a sale to certain IRC Section 678 techniques, which can only be initially funded with \$5,000.
- b. A QSST circumvents federal capital gains tax treatment on the sale of the subchapter S stock.

Under Internal Revenue Ruling 85-13, a sale by a taxpayer of an asset to a trust (that was not a grantor trust until the purchase occurred) in which the taxpayer is considered the owner for income tax purposes of the asset sold, both before and after the sale, is not subject to federal capital gains taxes. That Revenue Ruling discussed and followed a B.T.A. case, which held that a purchase of an asset from a bankruptcy trustee should be ignored for income tax purposes if the purchaser owned the asset both prior to and after the bankruptcy proceeding. Under IRC Section 1361(d)(1)(B), the beneficiary of a QSST is treated as the owner under IRC Section 678(a)(1) of that portion of the trust, which consists of subchapter S corporation stock. If the

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<sup>202</sup> See Treas. Reg. § 1.1361-1(j)(i).

<sup>203</sup> Under IRC Section 1361(d)(2)(D), the election can be retroactive for up to two months and fifteen days, so a timely election will cause IRC Section 678 to apply at the time of the sale.

<sup>204</sup> See PLR 914005 (June 25, 1991); PLR 200140046 (Oct. 5, 2001).

beneficiary of the QSST sells subchapter S stock that he individually owns to the QSST, he will own the stock for income tax purposes both before and after the sale. It should be noted that under Treasury Regulation § 1.1361-1(j)(8), if there is a sale at a later time of the subchapter S stock to a third party by the trustee of the trust, that sale will be taxable to the trust under the usual principles of subchapter J.

- c. There is not any concern about the effect of any lapse of withdrawal rights.

Unlike certain IRC Section 678 techniques, there is no need for the beneficiary of the QSST to have withdrawal rights, because there is no attempt to make the entire QSST a grantor trust, and withdrawal rights are not necessary for the subchapter S stock to constitute a grantor trust portion of the QSST. The transfer tax and income tax consequences that may accrue from the existence of a withdrawal right, and from its lapse, are not present in this technique.

- d. It has the advantage of allowing the seller to be a beneficiary of the trust and have a power of appointment over the trust.
- e. It has the potential of mitigating gift tax surprises.
- f. Appreciation will be out of the seller's estate.
- g. Flexibility goals may be met.

Under the terms of the trust and/or future trusts subject to Sam's power of appointment, the future stewardship goals of Sam to provide incentives and options for his children could be met. The financial capital of the trusts could also empower the children's goals. Sam will have the flexibility to change who the future beneficiaries of the trusts are, if his future stewardship goals change.

- h. Finally, Sam will have access to the cash flow of these trusts as the sole income beneficiary of the trusts.

Sam will also have access to the cash flow of any note on any sale from the trusts.

- i. The estate tax savings of the technique could be substantial.

See the table below and attached Schedule 15.

Table 16

| Hypothetical Results   | Assuming<br>Mr. and Mrs. Wilson<br>Die at the End of 5 Years | Assuming<br>Mr. and Mrs. Wilson<br>Die at the End of 15 Years | Assuming<br>Mr. and Mrs. Wilson<br>Die at the End of 30 Years |
|--|--|---|---|
|  | Estate Taxes at 40%  |   |   |
| No Further Planning; Bequeaths Estate to Family (assumes \$25.5mm estate tax exemption available)  | \$12,000,222   | \$20,627,272  | \$46,143,476  |
| Sales of Sub-Chapter S Non-Voting Stock to a Qualified Sub-Chapter S Trust (QSST) that is Created by a Third Party for the Benefit of the Seller and Seller's Family; Bequeaths Estate to Family (assumes \$25.5mm estate tax exemption available) | \$6,986,907  | \$9,154,659   | \$19,768,149  |

- j. The high-income trust income tax rates may be avoided if the beneficiary is in a lower bracket.
- k. The subchapter S corporation could re-invest its earnings, which would lower the income beneficiary's distributions and increase the remainder value.

3. Considerations of the technique.

- a. There may need to be substantive equity in the trust from prior gifts (is 10% equity enough?) before the sale is made.
- b. The disadvantages of utilizing a subchapter S corporation.

A subchapter S corporation is generally more advantageous from an income tax standpoint than a subchapter C corporation, because there are not any corporate taxes to be paid for a corporation that qualifies. A subchapter S corporation can own passively managed assets, if the corporation has never been a C corporation.

One of the disadvantages of a subchapter S corporation is that only certain shareholders may qualify. Individual shareholders must be United States citizens or resident aliens. However, foreign nationals may now be beneficiaries of an electing small business trust ("ESBT"). To the extent the subchapter S stock is owned by a trust, the trust needs to be a grantor trust, a QSST, BDOT or an ESBT. Of these, the only trusts to which sales of subchapter S stock may be without realization of gain are grantor trusts (sale by the grantor), BDOTs (sale by the withdrawal beneficiary) and QSSTs (sale by the trust beneficiary).

A general disadvantage of a subchapter S corporation is that there is not a step up on the underlying assets of the subchapter S corporation on the death of the shareholder who owns stock

that is subject to estate taxes.<sup>205</sup> However, this is a not significant consideration in this context, as the planning goal is to have the stock out of the client's estate by the time of the client's death.

- c. Need to file a federal gift tax return.
- d. Federal income tax considerations.

The income from the subchapter S stock that is owned by the QSST trust will be taxed to the beneficiary. The payment of income tax on trust income by the beneficiary is generally an advantageous result for federal transfer tax purposes. If the logic of Rev. Rul. 85-13, applies, the note should not be recognized for income tax purposes and the transferor should not be taxable on the interest on the note.

If the note is recognized for income tax purposes, the interest on the note should be deductible to the beneficiary of the trust (i.e., the transferor) under the separate share rules of IRC Section 663 or because of the fact that interest, at least to the extent paid from distributions from the S corporation, is being paid from the grantor portion of the QSST. Thus, if the note is recognized, both the interest income and the interest expense (which should constitute a "wash") should be reported on the transferor's income tax return. In the situation in which a QSST purchases S corporation stock from a third party (not the beneficiary) in exchange for a note the Office of the Chief Counsel ruled that the interest expense associated with the debt incurred by the QSST to acquire the S corporation stock is allocated to the grantor trust portion of the QSST thereby allowing the beneficiary to report the interest expense as a deduction on his personal income tax return.<sup>206</sup>

The Chief Counsel provided in the analysis the following:

"...Section 1.1361-1(j)(8) reiterates that the grantor is deemed to own the portion of the QSST consisting of the S corporation stock, but creates an exception when the QSST is determining and attributing the federal income tax consequences of a disposition of the S corporation stock. However, even within this exception there is an exception that again emphasizes the beneficiary's ownership interest. When the QSST disposes of the S corporation stock, the beneficiary is treated as personally disposing of the S corporation stock for purposes of applying §§ 465 and 469 to the beneficiary.

Applying the rules in § 1361(d), the S corporation stock is treated as though it is held in a grantor trust (the S portion). We should, therefore, look to the rules of subchapter J to determine which portion of the QSST receives the interest expense allocation. Under § 671 and the regulations thereunder, all items of income and deduction directly related to the grantor trust are attributed to the grantor. ...

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<sup>205</sup> By contrast, FLPs and LLCs, pursuant to certain elections that can be made under IRC Section 754, have the ability to have certain of the partnership assets receive an internal basis step up on the death of a partner or member who owns the partnership interest or member interest (assuming the assets have appreciated).

<sup>206</sup> CCA 201327009 (May 1, 2013).

The regulations under § 652(b) provide guidance for determining what deductions are allocable to different classes of income held by a trust. Section 1.652(b)-3(a) provides that all deductible items that are directly attributable to one class of income are allocated to that class. ...

The rules under § 163 provide guidance to determine to which class of income the interest expense incurred by the trust is allocated. The interest tracing rules (§ 1.163-8T) provide guidance in allocating interest expense for purposes of applying §§ 469 and 163(d) and (h). Section 163(d) limits the deduction for investment interest and § 163(h) allows a deduction for all but personal interest. The interest tracing rules provide that interest on a debt is allocated in the same manner as the debt to which the interest expense relates is allocated....”

Therefore, § 1.671-3(a)(2) would seem to require that based on § 1.652(b)-3 the interest expense deduction should be attributable to the S portion of the QSST and, thus, deductible by the beneficiary.

Any assets of the trust that are not subchapter S stock will be taxed trust under normal subchapter J rules.

As noted above, under Treas. Reg. § 1.1361-1(j)(8), if there is a sale by the trustee of the QSST of any subchapter S stock owned by the QSST, the QSST will be taxed on that sale under normal subchapter J principles. The basis of the subchapter S stock, that is to be sold, could be low because the only basis step-up will be the accumulated income of the corporation after the sale by the IRC Section 678 owner of the QSST. It may be very important to eliminate any note outstanding to the IRC Section 678 owner of the QSST, before the QSST sells its subchapter S stock to a third party, in order to circumvent any income tax complications associated with the outstanding debt.

e. State income tax considerations.

Certain states may have different tax rules with respect to subchapter S corporations and the taxation of QSST trusts. Thus, the possibility exists that under certain state laws, a sale to a QSST trust may be subject to state capital gains taxes and the beneficiary of the trust will not be taxed on the trust income.

- f. Could lose the benefits of using the gift tax exemption.
- g. Step transaction doctrine.
- h. Creditor rights and related estate tax issues. *See* the discussion *supra* Section V.B.5.
- i. Incomplete gift issues. *See* the discussion *supra* Section V.B.6.
- j. The transferor is the only beneficiary of the trust.

If the transferor wishes to have the flexibility to transfer trust assets to another family member, this technique will not allow the beneficiary to accomplish that purpose during the transferor's lifetime. However, the transferor could use other techniques to benefit the transferor's family.

## Schedule 1

### Gomer Gonetotexas

#### Hypothetical Integrated Income and Estate Tax Plan Comparisons (assuming Gomer Gonetotexas has a life expectancy of 20 years)

This is a hypothetical illustration of mathematical principles and is not a prediction or projection of performance of an investment or investment strategy.

This material is based on the assumptions stated herein. In the event any of the assumptions used do not prove to be true, results are likely to vary substantially from the examples shown herein. These examples are for illustrative purposes only and no representation is being made that any client will or is likely to achieve the results shown.

|  | 20-Year Future Values |                      | Present Values<br>(Discounted at 2.5%) | Percentage of Total |
|--|-----------------------|----------------------|--|---------------------|
|  | Pre-Death             | Post-Death           |  |                     |
| <b>No Further Planning: Bequeaths Estate to Family (assumes \$8.69mm inflation adjusted estate tax exemption available in 20 years)</b>  |                       |                      |  |                     |
| Gomer Gonetotexas  | 34,404,293            | -                    | -                                      | 0.00%               |
| Gonetotexas Children   | -                     | 15,428,576           | 9,415,611                              | 15.42%              |
| Gonetotexas Children and Grandchildren in California Complex Trust   | 9,609,259             | 9,609,259            | 5,864,252                              | 9.60%               |
| Gonetotexas Children and Grandchildren in Texas Grantor Trust  | -                     | 8,690,000            | 5,303,254                              | 8.68%               |
| Consumption - Direct Cost  | 12,772,329            | 12,772,329           | 7,794,581                              | 12.76%              |
| Consumption - Investment Opportunity Cost  | 13,053,175            | 13,053,175           | 7,965,974                              | 13.04%              |
| IRS & CA Income Tax - Direct Cost  | 3,894,601             | 3,894,601            | 2,376,762                              | 3.89%               |
| IRS & TX Income Tax - Direct Cost  | 11,640,362            | 11,640,362           | 7,103,775                              | 11.63%              |
| IRS & CA Income Tax - Investment Opportunity Cost  | 3,174,203             | 3,174,203            | 1,937,124                              | 3.17%               |
| IRS & TX Income Tax - Investment Opportunity Cost  | 11,520,158            | 11,520,158           | 7,030,417                              | 11.51%              |
| IRS Estate Tax (at 40.0%)  | -                     | 10,285,717           | 6,277,074                              | 10.28%              |
| <b>Total</b>   | <b>\$100,068,380</b>  | <b>\$100,068,380</b> | <b>\$61,068,825</b>                    | <b>100.00%</b>      |
| <b>Hypothetical Technique #1 - Scenario A: 6.0% Preferred Coupon Taxed Pro-Rata; California Complex Trust Owns Preferred; Bequeaths Estate to Family (assumes \$3.3mm inflation adjusted estate tax exemption available in 20 years)</b> |                       |                      |  |                     |
| Gomer Gonetotexas  | 20,522,418            | -                    | -                                      | 0.00%               |
| Gonetotexas Children   | -                     | 10,357,451           | 6,320,851                              | 10.35%              |
| Gonetotexas Children and Grandchildren in California Complex Trust   | 12,333,221            | 12,333,221           | 7,526,606                              | 12.32%              |
| Gonetotexas Children and Grandchildren in Texas Grantor Trust  | 12,199,872            | 15,459,872           | 9,434,710                              | 15.45%              |
| Consumption - Direct Cost  | 12,772,329            | 12,772,329           | 7,794,581                              | 12.76%              |
| Consumption - Investment Opportunity Cost  | 13,053,175            | 13,053,175           | 7,965,974                              | 13.04%              |
| IRS & CA Income Tax - Direct Cost  | 3,085,931             | 3,085,931            | 1,883,254                              | 3.08%               |
| IRS & TX Income Tax - Direct Cost  | 12,289,889            | 12,289,889           | 7,500,162                              | 12.28%              |
| IRS & CA Income Tax - Investment Opportunity Cost  | 2,860,359             | 2,860,359            | 1,745,594                              | 2.86%               |
| IRS & TX Income Tax - Investment Opportunity Cost  | 11,746,826            | 11,746,826           | 7,168,746                              | 11.74%              |
| Opportunity Cost/(Benefit) of Third Party Note   | (795,639)             | (795,639)            | (485,555)                              | -0.80%              |
| IRS Estate Tax (at 40.0%)  | -                     | 6,904,967            | 4,213,901                              | 6.90%               |
| <b>Total</b>   | <b>\$100,068,380</b>  | <b>\$100,068,380</b> | <b>\$61,068,825</b>                    | <b>100.00%</b>      |
| <b>Hypothetical Technique #1 - Scenario B: 3.0% Preferred Coupon Taxed Pro-Rata; California Complex Trust Owns Preferred; Bequeaths Estate to Family (assumes \$3.3mm inflation adjusted estate tax exemption available in 20 years)</b> |                       |                      |  |                     |
| Gomer Gonetotexas  | 20,201,883            | -                    | -                                      | 0.00%               |
| Gonetotexas Children   | -                     | 10,165,130           | 6,203,483                              | 10.16%              |
| Gonetotexas Children and Grandchildren in California Complex Trust   | 10,164,400            | 10,164,400           | 6,203,038                              | 10.16%              |
| Gonetotexas Children and Grandchildren in Texas Grantor Trust  | 15,378,941            | 18,638,941           | 11,374,804                             | 18.63%              |
| Consumption - Direct Cost  | 12,772,329            | 12,772,329           | 7,794,581                              | 12.76%              |
| Consumption - Investment Opportunity Cost  | 13,053,175            | 13,053,175           | 7,965,974                              | 13.04%              |
| IRS & CA Income Tax - Direct Cost  | 1,543,906             | 1,543,906            | 942,201                                | 1.54%               |
| IRS & TX Income Tax - Direct Cost  | 13,537,376            | 13,537,376           | 8,261,467                              | 13.53%              |
| IRS & CA Income Tax - Investment Opportunity Cost  | 1,431,450             | 1,431,450            | 873,572                                | 1.43%               |
| IRS & TX Income Tax - Investment Opportunity Cost  | 12,936,697            | 12,936,697           | 7,894,890                              | 12.93%              |
| Opportunity Cost/(Benefit) of Third Party Note   | (951,776)             | (951,776)            | (580,841)                              | -0.95%              |
| IRS Estate Tax (at 40.0%)  | -                     | 6,776,753            | 4,135,655                              | 6.77%               |
| <b>Total</b>   | <b>\$100,068,380</b>  | <b>\$100,068,380</b> | <b>\$61,068,825</b>                    | <b>100.00%</b>      |

Download large-format schedules here: [https://oregonstatebar.s3-us-west-2.amazonaws.com/Seminars/2020/OTI20\\_Chapter\\_1\\_Schedules.pdf](https://oregonstatebar.s3-us-west-2.amazonaws.com/Seminars/2020/OTI20_Chapter_1_Schedules.pdf)

### Schedule 1

#### Gomer Gonetotexas

#### Asset Page

This is a hypothetical illustration of mathematical principles and is not a prediction or projection of performance of an investment or investment strategy.

This material is based on the assumptions stated herein. In the event any of the assumptions used do not prove to be true, results are likely to vary substantially from the examples shown herein. These examples are for illustrative purposes only and no representation is being made that any client will or is likely to achieve the results shown.

|  | Gomer<br>Gonetotexas | California<br>Complex<br>Trust |
|--|----------------------|--------------------------------|
| <b>Assets* (assumed value and basis)</b> |                      |                                |
| FMV: Financial Assets                    | \$20,000,000         | \$4,000,000                    |
| Basis: Financial Assets                  | \$20,000,000         | \$4,000,000                    |

\* Information provided by client. There is no proposed planning for Mr. Gonetotexas' other assets.

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## Chapter 1—Some of the Best Creative Tax Planning Techniques for Trusts©

### Schedule 1

#### Gomer Gonetotexas

#### No Further Planning: Bequeaths Estate to Family (assumes \$8.69mm inflation adjusted estate tax exemption available in 20 years)

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| Assumptions:                                       |           |
|--|-----------|
| Total Estimated Rate of Return - Financial Assets  | 7.40%     |
| Rate of Return Taxed at Ordinary Rates             | 3.00%     |
| Rate of Return Taxed at Capital Gains Rates        | 4.40%     |
| Turnover Rate (% of Capital Gains Recognized/Year) | 30.00%    |
| Annual Consumption (increasing 2.5% per year)      | \$500,000 |

| Assumptions - Income Taxes:                      | California | Texas  |
|--|------------|--------|
| Long-Term Capital Gains and Health Care Tax Rate | 33.03%     | 25.00% |
| Ordinary Income and Health Care Tax Rate         | 52.63%     | 44.60% |

#### Gomer Gonetotexas (Texas Residents)

|         | Beginning of Year |         |           |             | End of Year Financial Assets |
|---------|-------------------|---------|-----------|-------------|------------------------------|
|         | Financial Assets  | Income  | Growth    | Consumption |                              |
| Year 1  | 20,000,000        | 600,000 | 880,000   | (500,000)   | (333,600)                    |
| Year 2  | 20,646,400        | 619,392 | 908,442   | (512,500)   | (390,582)                    |
| Year 3  | 21,271,152        | 638,135 | 935,931   | (525,313)   | (434,836)                    |
| Year 4  | 21,885,068        | 656,552 | 962,943   | (538,445)   | (470,203)                    |
| Year 5  | 22,495,916        | 674,877 | 989,820   | (551,906)   | (499,398)                    |
| Year 6  | 23,109,309        | 693,279 | 1,016,810 | (565,704)   | (524,345)                    |
| Year 7  | 23,729,348        | 711,880 | 1,044,091 | (579,847)   | (546,405)                    |
| Year 8  | 24,359,068        | 730,772 | 1,071,799 | (594,343)   | (566,544)                    |
| Year 9  | 25,000,752        | 750,023 | 1,100,033 | (609,201)   | (585,446)                    |
| Year 10 | 25,656,160        | 769,685 | 1,128,871 | (624,431)   | (603,600)                    |
| Year 11 | 26,326,684        | 789,801 | 1,158,374 | (640,042)   | (621,354)                    |
| Year 12 | 27,013,463        | 810,404 | 1,188,592 | (656,043)   | (638,956)                    |
| Year 13 | 27,717,460        | 831,524 | 1,219,568 | (672,444)   | (656,589)                    |
| Year 14 | 28,439,519        | 853,186 | 1,251,339 | (689,256)   | (674,381)                    |
| Year 15 | 29,180,406        | 875,412 | 1,283,938 | (706,487)   | (692,432)                    |
| Year 16 | 29,940,838        | 898,225 | 1,317,397 | (724,149)   | (710,812)                    |
| Year 17 | 30,721,499        | 921,645 | 1,351,746 | (742,253)   | (729,577)                    |
| Year 18 | 31,523,060        | 945,692 | 1,387,015 | (760,809)   | (748,771)                    |
| Year 19 | 32,346,187        | 970,386 | 1,423,232 | (779,829)   | (768,429)                    |
| Year 20 | 33,191,546        | 995,746 | 1,460,428 | (799,325)   | (744,103)                    |

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# Chapter 1—Some of the Best Creative Tax Planning Techniques for Trusts©

## Schedule 1

### Gomer Gonetotexas

#### No Further Planning: Bequeaths Estate to Family (assumes \$8.69mm inflation adjusted estate tax exemption available in 20 years)

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| Rate of Return Taxed at Capital Gains Rates        | 4.40%     |
| Turnover Rate (% of Capital Gains Recognized/Year) | 30.00%    |
| Annual Consumption (increasing 2.5% per year)      | \$500,000 |

| Assumptions - Income Taxes:                      |  | California | Texas  |
|--|--|------------|--------|
| Long-Term Capital Gains and Health Care Tax Rate |  | 33.03%     | 25.00% |
| Ordinary Income and Health Care Tax Rate         |  | 52.63%     | 44.60% |

### California Complex Trust

|         | Beginning of Year |         |         |                           | End of Year Financial Assets |
|---------|-------------------|---------|---------|---------------------------|------------------------------|
|         | Financial Assets  | Income  | Growth  | Beneficiary Distributions |                              |
| Year 1  | 4,000,000         | 120,000 | 176,000 | -                         | (80,601)                     |
| Year 2  | 4,215,399         | 126,462 | 185,478 | -                         | (97,151)                     |
| Year 3  | 4,430,187         | 132,906 | 194,928 | -                         | (110,683)                    |
| Year 4  | 4,647,339         | 139,420 | 204,483 | -                         | (122,157)                    |
| Year 5  | 4,869,085         | 146,073 | 214,240 | -                         | (132,256)                    |
| Year 6  | 5,097,141         | 152,914 | 224,274 | -                         | (141,471)                    |
| Year 7  | 5,322,858         | 159,986 | 234,646 | -                         | (150,150)                    |
| Year 8  | 5,547,340         | 167,320 | 245,403 | -                         | (158,546)                    |
| Year 9  | 5,831,517         | 174,946 | 256,587 | -                         | (166,843)                    |
| Year 10 | 6,096,206         | 182,886 | 268,233 | -                         | (175,175)                    |
| Year 11 | 6,372,150         | 191,164 | 280,375 | -                         | (183,643)                    |
| Year 12 | 6,660,046         | 199,801 | 293,042 | -                         | (192,321)                    |
| Year 13 | 6,960,569         | 208,817 | 306,265 | -                         | (201,269)                    |
| Year 14 | 7,274,382         | 218,231 | 320,073 | -                         | (210,535)                    |
| Year 15 | 7,602,151         | 228,065 | 334,495 | -                         | (220,157)                    |
| Year 16 | 7,944,554         | 238,337 | 349,560 | -                         | (230,169)                    |
| Year 17 | 8,302,282         | 249,068 | 365,300 | -                         | (240,601)                    |
| Year 18 | 8,676,050         | 260,281 | 381,746 | -                         | (251,481)                    |
| Year 19 | 9,066,596         | 271,998 | 398,930 | -                         | (262,836)                    |
| Year 20 | 9,474,689         | 284,241 | 416,886 | -                         | (566,556)                    |
|         |                   |         |         |                           | 9,609,259                    |

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## Chapter 1—Some of the Best Creative Tax Planning Techniques for Trusts©

### Schedule 1

#### Gomer Gonetotexas

**Hypothetical Technique #1 - Scenario A: 6.0% Preferred Coupon Taxed Pro-Rata; California Complex Trust Owns Preferred; Bequeaths Estate to Family (assumes \$3.3mm inflation adjusted estate tax exemption available in 20 years)**

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| Rate of Return Taxed at Ordinary Rates             | 3.00%       |
| Rate of Return Taxed at Capital Gains Rates        | 4.40%       |
| Turnover Rate (% of Capital Gains Recognized/Year) | 30.00%      |
| Annual Consumption (increasing 2.5% per year)      | \$500,000   |
| Gift to Texas GST Tax Exempt Grantor Trust         | \$5,430,000 |

| <b>Assumptions - Income Taxes:</b>               |             |        |
|--|-------------|--------|
|  | California  | Texas  |
| Long-Term Capital Gains and Health Care Tax Rate | 33.03%      | 25.00% |
| Ordinary Income and Health Care Tax Rate         | 52.63%      | 44.60% |
| <b>Assumptions - Family Limited Partnership:</b> |             |        |
| FLP Preferred Interest                           | \$4,000,000 |        |
| FLP Preferred Coupon                             | 6.0%        |        |
| FLP Valuation Discount                           | 35.0%       |        |
| <b>Assumptions - Other:</b>                      |             |        |
| 3rd Party Note Interest Rate                     | 3.00%       |        |

#### Gomer Gonetotexas (Texas Resident)

|         | Beginning of Year |         | FLP     | 3rd Party Note Payments |              | Income Taxes | End of Year Financial Assets |
|---------|-------------------|---------|---------|-------------------------|--------------|--------------|------------------------------|
|         | Financial Assets  | Income  |         | Growth                  | Terminates   |              |                              |
| Year 1  | 14,570,000        | 437,100 | 641,080 | -                       | -            | (500,000)    | (307,653)                    |
| Year 2  | 14,840,527        | 445,216 | 652,983 | -                       | -            | (512,500)    | (380,777)                    |
| Year 3  | 15,045,449        | 451,363 | 662,000 | -                       | -            | (525,313)    | (435,637)                    |
| Year 4  | 15,197,863        | 455,936 | 668,706 | -                       | -            | (538,445)    | (478,476)                    |
| Year 5  | 15,305,583        | 459,167 | 673,446 | -                       | -            | (551,906)    | (513,184)                    |
| Year 6  | 15,373,105        | 461,193 | 676,417 | -                       | -            | (565,704)    | (542,367)                    |
| Year 7  | 15,402,644        | 462,079 | 677,716 | -                       | -            | (579,847)    | (567,820)                    |
| Year 8  | 15,394,773        | 461,843 | 677,370 | -                       | -            | (594,343)    | (590,795)                    |
| Year 9  | 15,348,848        | 460,465 | 675,349 | -                       | -            | (609,201)    | (612,174)                    |
| Year 10 | 15,263,288        | 457,899 | 671,585 | -                       | -            | (624,431)    | (632,580)                    |
| Year 11 | 15,135,759        | 454,073 | 665,973 | -                       | -            | (640,042)    | (652,456)                    |
| Year 12 | 14,963,307        | 448,899 | 658,386 | -                       | -            | (656,043)    | (672,120)                    |
| Year 13 | 14,742,428        | 442,273 | 648,667 | -                       | -            | (672,444)    | (691,800)                    |
| Year 14 | 14,469,123        | 434,074 | 636,641 | -                       | -            | (689,256)    | (711,663)                    |
| Year 15 | 14,138,920        | 424,168 | 622,112 | -                       | -            | (706,487)    | (731,830)                    |
| Year 16 | 13,746,883        | 412,406 | 604,863 | -                       | -            | (724,149)    | (752,396)                    |
| Year 17 | 13,287,607        | 398,628 | 584,655 | -                       | -            | (742,253)    | (773,431)                    |
| Year 18 | 12,755,206        | 382,656 | 561,229 | -                       | (421,332)    | (760,809)    | (607,078)                    |
| Year 19 | 11,909,872        | 357,296 | 524,034 | -                       | (421,332)    | (779,829)    | (859,577)                    |
| Year 20 | 10,730,464        | 321,914 | 472,140 | 25,039,023              | (14,465,726) | (799,325)    | (776,073)                    |

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# Chapter 1—Some of the Best Creative Tax Planning Techniques for Trusts©

## Schedule 1

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| Rate of Return Taxed at Capital Gains Rates        | 4.40%       |
| Turnover Rate (% of Capital Gains Recognized/Year) | 30.00%      |
| Annual Consumption (increasing 2.5% per year)      | \$500,000   |
| Gift to Texas GST Tax Exempt Grantor Trust         | \$5,430,000 |

| <b>Assumptions - Income Taxes:</b>               | <b>California</b> | <b>Texas</b> |
|--|-------------------|--------------|
| Long-Term Capital Gains and Health Care Tax Rate | 33.03%            | 25.00%       |
| Ordinary Income and Health Care Tax Rate         | 52.63%            | 44.60%       |
| <b>Assumptions - Family Limited Partnership:</b> |                   |              |
| FLP Preferred Interest                           |                   | \$4,000,000  |
| FLP Preferred Coupon                             |                   | 6.0%         |
| FLP Valuation Discount                           |                   | 35.0%        |
| <b>Assumptions - Other:</b>                      |                   |              |
| 3rd Party Note Interest Rate                     |                   | 3.00%        |

### Family Limited Partnership

|         | <b>Beginning of Year Financial Assets</b> | <b>Income</b> | <b>Growth</b> | <b>Preferred Distributions</b> | <b>Growth Distributions</b> | <b>FLP Terminates</b> | <b>End of Year Financial Assets</b> |
|---------|---|---------------|---------------|--------------------------------|-----------------------------|-----------------------|-------------------------------------|
| Year 1  | 9,430,000                                 | 282,900       | 414,920       | (240,000)                      | -                           | -                     | 9,887,820                           |
| Year 2  | 9,887,820                                 | 296,635       | 435,064       | (240,000)                      | -                           | -                     | 10,379,519                          |
| Year 3  | 10,379,519                                | 311,386       | 456,699       | (240,000)                      | -                           | -                     | 10,907,603                          |
| Year 4  | 10,907,603                                | 327,228       | 479,935       | (240,000)                      | -                           | -                     | 11,474,766                          |
| Year 5  | 11,474,766                                | 344,243       | 504,890       | (240,000)                      | -                           | -                     | 12,083,898                          |
| Year 6  | 12,083,898                                | 362,517       | 531,692       | (240,000)                      | -                           | -                     | 12,738,107                          |
| Year 7  | 12,738,107                                | 382,143       | 560,477       | (240,000)                      | -                           | -                     | 13,440,727                          |
| Year 8  | 13,440,727                                | 403,222       | 591,392       | (240,000)                      | -                           | -                     | 14,195,341                          |
| Year 9  | 14,195,341                                | 425,860       | 624,595       | (240,000)                      | -                           | -                     | 15,005,796                          |
| Year 10 | 15,005,796                                | 450,174       | 660,255       | (240,000)                      | -                           | -                     | 15,876,225                          |
| Year 11 | 15,876,225                                | 476,287       | 698,554       | (240,000)                      | -                           | -                     | 16,811,065                          |
| Year 12 | 16,811,065                                | 504,332       | 739,687       | (240,000)                      | -                           | -                     | 17,815,084                          |
| Year 13 | 17,815,084                                | 534,453       | 783,864       | (240,000)                      | -                           | -                     | 18,893,400                          |
| Year 14 | 18,893,400                                | 566,802       | 831,310       | (240,000)                      | -                           | -                     | 20,051,512                          |
| Year 15 | 20,051,512                                | 601,545       | 882,267       | (240,000)                      | -                           | -                     | 21,295,324                          |
| Year 16 | 21,295,324                                | 638,860       | 936,994       | (240,000)                      | -                           | -                     | 22,631,178                          |
| Year 17 | 22,631,178                                | 678,935       | 995,772       | (240,000)                      | -                           | -                     | 24,065,885                          |
| Year 18 | 24,065,885                                | 721,977       | 1,058,899     | (240,000)                      | -                           | -                     | 25,606,760                          |
| Year 19 | 25,606,760                                | 768,203       | 1,126,697     | (240,000)                      | -                           | -                     | 27,261,661                          |
| Year 20 | 27,261,661                                | 817,850       | 1,199,513     | (240,000)                      | -                           | (29,039,023)          | -                                   |

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| Annual Consumption (increasing 2.5% per year)      | \$500,000   |
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| <b>Assumptions - Income Taxes:</b>               |                   |              |
|--|-------------------|--------------|
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| <b>Assumptions - Family Limited Partnership:</b> |                   |              |
| FLP Preferred Interest                           | \$4,000,000       |              |
| FLP Preferred Coupon                             |                   | 6.0%         |
| FLP Valuation Discount                           |                   | 35.0%        |
| <b>Assumptions - Other:</b>                      |                   |              |
| 3rd Party Note Interest Rate                     |                   | 3.00%        |

### California Complex Trust

|         | California Complex Trust           |         |         |                             |                |                           |                              |
|---------|------------------------------------|---------|---------|-----------------------------|----------------|---------------------------|------------------------------|
|         | Beginning of Year Financial Assets | Income  | Growth  | FLP Preferred Distributions | FLP Terminates | Beneficiary Distributions | End of Year Financial Assets |
| Year 1  | -                                  | -       | -       | 240,000                     | -              | -                         | (111,946)                    |
| Year 2  | 128,054                            | 3,842   | 5,634   | 240,000                     | -              | -                         | (108,992)                    |
| Year 3  | 208,538                            | 8,056   | 11,816  | 240,000                     | -              | -                         | (109,464)                    |
| Year 4  | 418,946                            | 12,568  | 18,434  | 240,000                     | -              | -                         | (111,661)                    |
| Year 5  | 578,287                            | 17,349  | 25,445  | 240,000                     | -              | -                         | (114,910)                    |
| Year 6  | 746,170                            | 22,385  | 32,831  | 240,000                     | -              | -                         | (118,884)                    |
| Year 7  | 922,502                            | 27,675  | 40,590  | 240,000                     | -              | -                         | (123,407)                    |
| Year 8  | 1,107,360                          | 33,221  | 48,724  | 240,000                     | -              | -                         | (128,375)                    |
| Year 9  | 1,300,930                          | 39,028  | 57,241  | 240,000                     | -              | -                         | (133,727)                    |
| Year 10 | 1,503,471                          | 45,104  | 66,153  | 240,000                     | -              | -                         | (139,429)                    |
| Year 11 | 1,715,300                          | 51,459  | 75,473  | 240,000                     | -              | -                         | (145,459)                    |
| Year 12 | 1,936,773                          | 58,103  | 85,218  | 240,000                     | -              | -                         | (151,810)                    |
| Year 13 | 2,168,284                          | 65,049  | 95,404  | 240,000                     | -              | -                         | (158,480)                    |
| Year 14 | 2,410,256                          | 72,308  | 106,051 | 240,000                     | -              | -                         | (165,472)                    |
| Year 15 | 2,663,143                          | 79,894  | 117,178 | 240,000                     | -              | -                         | (172,794)                    |
| Year 16 | 2,927,422                          | 87,823  | 128,807 | 240,000                     | -              | -                         | (180,454)                    |
| Year 17 | 3,203,597                          | 96,108  | 140,958 | 240,000                     | -              | -                         | (188,465)                    |
| Year 18 | 3,492,199                          | 104,766 | 153,657 | 240,000                     | -              | -                         | (196,839)                    |
| Year 19 | 3,793,783                          | 113,813 | 166,926 | 240,000                     | -              | -                         | (205,593)                    |
| Year 20 | 4,108,930                          | 123,268 | 180,793 | 240,000                     | 4,000,000      | -                         | (319,770)                    |

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| Annual Consumption (increasing 2.5% per year)      | \$500,000   |
| Gift to Texas GST Tax Exempt Grantor Trust         | \$5,430,000 |

| <b>Assumptions - Income Taxes:</b>               |             |        |
|--|-------------|--------|
|  | California  | Texas  |
| Long-Term Capital Gains and Health Care Tax Rate | 33.03%      | 25.00% |
| Ordinary Income and Health Care Tax Rate         | 52.63%      | 44.60% |
| <b>Assumptions - Family Limited Partnership:</b> |             |        |
| FLP Preferred Interest                           | \$4,000,000 |        |
| FLP Preferred Coupon                             |             | 6.0%   |
| FLP Valuation Discount                           |             | 35.0%  |
| <b>Assumptions - Other:</b>                      |             |        |
| 3rd Party Note Interest Rate                     |             | 3.00%  |

#### Texas GST Tax Exempt Grantor Trust

|         | Beginning of Year Financial Assets | Income  | Growth  | FLP Growth Distributions | Asset Purchase Proceeds | Beneficiary Distributions | Income Taxes | End of Year Financial Assets |
|---------|------------------------------------|---------|---------|--------------------------|-------------------------|---------------------------|--------------|------------------------------|
| Year 1  | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 2  | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 3  | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 4  | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 5  | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 6  | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 7  | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 8  | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 9  | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 10 | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 11 | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 12 | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 13 | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 14 | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 15 | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 16 | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 17 | -                                  | -       | -       | -                        | -                       | -                         | -            | -                            |
| Year 18 | -                                  | -       | -       | -                        | 14,044,394              | -                         | -            | 14,044,394                   |
| Year 19 | 14,044,394                         | 421,332 | 617,953 | -                        | -                       | -                         | -            | 15,083,679                   |
| Year 20 | 15,083,679                         | 452,510 | 663,682 | -                        | -                       | -                         | -            | 16,199,872                   |

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## Chapter 1—Some of the Best Creative Tax Planning Techniques for Trusts©

### Schedule 1

#### Gomer Gonetotexas

**Hypothetical Technique #1 - Scenario A: 6.0% Preferred Coupon Taxed Pro-Rata; California Complex Trust Owns Preferred; Bequeaths Estate to Family (assumes \$3.3mm inflation adjusted estate tax exemption available in 20 years)**

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| <b>Assumptions:</b>                                |             |
|--|-------------|
| Total Estimated Rate of Return - Financial Assets  | 7.40%       |
| Rate of Return Taxed at Ordinary Rates             | 3.00%       |
| Rate of Return Taxed at Capital Gains Rates        | 4.40%       |
| Turnover Rate (% of Capital Gains Recognized/Year) | 30.00%      |
| Annual Consumption (increasing 2.5% per year)      | \$500,000   |
| Gift to Texas GST Tax Exempt Grantor Trust         | \$5,430,000 |

| <b>Assumptions - Income Taxes:</b>               |             |        |
|--|-------------|--------|
|  | California  | Texas  |
| Long-Term Capital Gains and Health Care Tax Rate | 33.03%      | 25.00% |
| Ordinary Income and Health Care Tax Rate         | 52.63%      | 44.60% |
| <b>Assumptions - Family Limited Partnership:</b> |             |        |
| FLP Preferred Interest                           | \$4,000,000 |        |
| FLP Preferred Coupon                             | 6.0%        |        |
| FLP Valuation Discount                           | 35.0%       |        |
| <b>Assumptions - Other:</b>                      |             |        |
| 3rd Party Note Interest Rate                     | 3.00%       |        |

#### Note Between Gomer Gonetotexas and 3rd Party Lender

|         | Beginning<br>of Year<br>Principal | Interest | Note<br>Payments | End of Year<br>Principal |
|---------|-----------------------------------|----------|------------------|--------------------------|
| Year 1  | -                                 | -        | -                | -                        |
| Year 2  | -                                 | -        | -                | -                        |
| Year 3  | -                                 | -        | -                | -                        |
| Year 4  | -                                 | -        | -                | -                        |
| Year 5  | -                                 | -        | -                | -                        |
| Year 6  | -                                 | -        | -                | -                        |
| Year 7  | -                                 | -        | -                | -                        |
| Year 8  | -                                 | -        | -                | -                        |
| Year 9  | -                                 | -        | -                | -                        |
| Year 10 | -                                 | -        | -                | -                        |
| Year 11 | -                                 | -        | -                | -                        |
| Year 12 | -                                 | -        | -                | -                        |
| Year 13 | -                                 | -        | -                | -                        |
| Year 14 | -                                 | -        | -                | -                        |
| Year 15 | -                                 | -        | -                | -                        |
| Year 16 | -                                 | -        | -                | -                        |
| Year 17 | -                                 | -        | -                | -                        |
| Year 18 | 14,044,394                        | 421,332  | (421,332)        | 14,044,394               |
| Year 19 | 14,044,394                        | 421,332  | (421,332)        | 14,044,394               |
| Year 20 | 14,044,394                        | 421,332  | (14,465,726)     | -                        |

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## Chapter 1—Some of the Best Creative Tax Planning Techniques for Trusts©

### Schedule 1

#### Gomer Gonetotexas

**Hypothetical Technique #1 - Scenario B: 3.0% Preferred Coupon Taxed Pro-Rata; California Complex Trust Owns Preferred; Bequeaths Estate to Family (assumes \$3.3mm inflation adjusted estate tax exemption available in 20 years)**

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| Rate of Return Taxed at Capital Gains Rates        | 4.40%       |
| Turnover Rate (% of Capital Gains Recognized/Year) | 30.00%      |
| Annual Consumption (increasing 2.5% per year)      | \$500,000   |
| Gift to Texas GST Tax Exempt Grantor Trust         | \$5,430,000 |

| <b>Assumptions - Income Taxes:</b>               |                   |              |
|--|-------------------|--------------|
|  | <b>California</b> | <b>Texas</b> |
| Long-Term Capital Gains and Health Care Tax Rate | 33.03%            | 25.00%       |
| Ordinary Income and Health Care Tax Rate         | 52.63%            | 44.60%       |
| <b>Assumptions - Family Limited Partnership:</b> |                   |              |
| FLP Preferred Interest                           | \$4,000,000       |              |
| FLP Preferred Coupon                             | 3.00%             |              |
| FLP Valuation Discount                           | 35.00%            |              |
| <b>Assumptions - Other:</b>                      |                   |              |
| 3rd Party Note Interest Rate                     | 3.00%             |              |

#### Gomer Gonetotexas (Texas Resident)

|         | Beginning of Year |         |         |                |               |             |              | <b>End of Year Financial Assets</b> |
|---------|-------------------|---------|---------|----------------|---------------|-------------|--------------|-------------------------------------|
|         | Financial Assets  | Income  | Growth  | FLP Terminates | Note Payments | Consumption | Income Taxes |                                     |
| Year 1  | 14,570,000        | 437,100 | 641,080 | -              | -             | (500,000)   | (353,987)    | 14,794,193                          |
| Year 2  | 14,794,193        | 443,826 | 650,945 | -              | -             | (512,500)   | (425,544)    | 14,950,920                          |
| Year 3  | 14,950,920        | 448,528 | 657,840 | -              | -             | (525,313)   | (480,522)    | 15,051,453                          |
| Year 4  | 15,051,453        | 451,544 | 662,264 | -              | -             | (538,445)   | (524,325)    | 15,102,490                          |
| Year 5  | 15,102,490        | 453,075 | 664,510 | -              | -             | (551,906)   | (560,513)    | 15,107,656                          |
| Year 6  | 15,107,656        | 453,230 | 664,737 | -              | -             | (565,704)   | (591,532)    | 15,068,386                          |
| Year 7  | 15,068,386        | 452,052 | 663,009 | -              | -             | (579,847)   | (619,094)    | 14,984,505                          |
| Year 8  | 14,984,505        | 449,535 | 659,318 | -              | -             | (594,343)   | (644,402)    | 14,854,614                          |
| Year 9  | 14,854,614        | 445,638 | 653,603 | -              | -             | (609,201)   | (668,309)    | 14,676,345                          |
| Year 10 | 14,676,345        | 440,290 | 645,759 | -              | -             | (624,431)   | (691,424)    | 14,446,539                          |
| Year 11 | 14,446,539        | 433,396 | 635,648 | -              | -             | (640,042)   | (714,181)    | 14,161,360                          |
| Year 12 | 14,161,360        | 424,841 | 623,100 | -              | -             | (656,043)   | (736,894)    | 13,816,363                          |
| Year 13 | 13,816,363        | 414,491 | 607,920 | -              | -             | (672,444)   | (759,794)    | 13,406,536                          |
| Year 14 | 13,406,536        | 402,196 | 589,888 | -              | -             | (689,256)   | (783,050)    | 12,926,314                          |
| Year 15 | 12,926,314        | 387,789 | 568,758 | -              | -             | (706,487)   | (806,789)    | 12,369,585                          |
| Year 16 | 12,369,585        | 371,088 | 544,262 | -              | -             | (724,149)   | (831,112)    | 11,729,674                          |
| Year 17 | 11,729,674        | 351,890 | 516,106 | -              | -             | (742,253)   | (856,097)    | 10,999,320                          |
| Year 18 | 10,999,320        | 329,980 | 483,970 | -              | (504,014)     | (760,809)   | (657,018)    | 9,891,429                           |
| Year 19 | 9,891,429         | 296,743 | 435,223 | -              | (504,014)     | (779,829)   | (959,087)    | 8,380,464                           |
| Year 20 | 8,380,464         | 251,414 | 368,740 | 30,178,779     | (17,304,486)  | (799,325)   | (873,703)    | 20,201,883                          |

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## Chapter 1—Some of the Best Creative Tax Planning Techniques for Trusts©

### Schedule 1

#### Gomer Gonetotexas

**Hypothetical Technique #1 - Scenario B: 3.0% Preferred Coupon Taxed Pro-Rata; California Complex Trust Owns Preferred; Bequeaths Estate to Family (assumes \$3.3mm inflation adjusted estate tax exemption available in 20 years)**

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|--|-------------|
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| Rate of Return Taxed at Ordinary Rates             | 3.00%       |
| Rate of Return Taxed at Capital Gains Rates        | 4.40%       |
| Turnover Rate (% of Capital Gains Recognized/Year) | 30.00%      |
| Annual Consumption (increasing 2.5% per year)      | \$500,000   |
| Gift to Texas GST Tax Exempt Grantor Trust         | \$5,430,000 |

| <b>Assumptions - Income Taxes:</b>               | <b>California</b> | <b>Texas</b> |
|--|-------------------|--------------|
| Long-Term Capital Gains and Health Care Tax Rate | 33.03%            | 25.00%       |
| Ordinary Income and Health Care Tax Rate         | 52.63%            | 44.60%       |
| <b>Assumptions - Family Limited Partnership:</b> |                   |              |
| FLP Preferred Interest                           |                   | \$4,000,000  |
| FLP Preferred Coupon                             |                   | 3.00%        |
| FLP Valuation Discount                           |                   | 35.00%       |
| <b>Assumptions - Other:</b>                      |                   |              |
| 3rd Party Note Interest Rate                     |                   | 3.00%        |

#### Family Limited Partnership

|         | <b>Beginning of Year Financial Assets</b> | <b>Income</b> | <b>Growth</b> | <b>Preferred Distributions</b> | <b>Growth Distributions</b> | <b>FLP Terminates</b> | <b>End of Year Financial Assets</b> |
|---------|---|---------------|---------------|--------------------------------|-----------------------------|-----------------------|-------------------------------------|
| Year 1  | 9,430,000                                 | 282,900       | 414,920       | (120,000)                      | -                           | -                     | 10,007,820                          |
| Year 2  | 10,007,820                                | 300,235       | 440,344       | (120,000)                      | -                           | -                     | 10,628,399                          |
| Year 3  | 10,628,399                                | 318,852       | 467,650       | (120,000)                      | -                           | -                     | 11,294,900                          |
| Year 4  | 11,294,900                                | 338,847       | 496,976       | (120,000)                      | -                           | -                     | 12,010,723                          |
| Year 5  | 12,010,723                                | 360,322       | 528,472       | (120,000)                      | -                           | -                     | 12,779,516                          |
| Year 6  | 12,779,516                                | 383,385       | 562,299       | (120,000)                      | -                           | -                     | 13,605,200                          |
| Year 7  | 13,605,200                                | 408,156       | 598,629       | (120,000)                      | -                           | -                     | 14,491,985                          |
| Year 8  | 14,491,985                                | 434,760       | 637,647       | (120,000)                      | -                           | -                     | 15,444,392                          |
| Year 9  | 15,444,392                                | 463,332       | 679,553       | (120,000)                      | -                           | -                     | 16,467,277                          |
| Year 10 | 16,467,277                                | 494,018       | 724,560       | (120,000)                      | -                           | -                     | 17,565,856                          |
| Year 11 | 17,565,856                                | 526,976       | 772,898       | (120,000)                      | -                           | -                     | 18,745,729                          |
| Year 12 | 18,745,729                                | 562,372       | 824,812       | (120,000)                      | -                           | -                     | 20,012,913                          |
| Year 13 | 20,012,913                                | 600,387       | 880,568       | (120,000)                      | -                           | -                     | 21,373,869                          |
| Year 14 | 21,373,869                                | 641,216       | 940,450       | (120,000)                      | -                           | -                     | 22,835,535                          |
| Year 15 | 22,835,535                                | 685,066       | 1,004,764     | (120,000)                      | -                           | -                     | 24,405,364                          |
| Year 16 | 24,405,364                                | 732,161       | 1,073,836     | (120,000)                      | -                           | -                     | 26,091,361                          |
| Year 17 | 26,091,361                                | 782,741       | 1,148,020     | (120,000)                      | -                           | -                     | 27,902,122                          |
| Year 18 | 27,902,122                                | 837,064       | 1,227,693     | (120,000)                      | -                           | -                     | 29,846,879                          |
| Year 19 | 29,846,879                                | 895,406       | 1,313,263     | (120,000)                      | -                           | -                     | 31,935,548                          |
| Year 20 | 31,935,548                                | 958,066       | 1,405,164     | (120,000)                      | -                           | (34,178,779)          | -                                   |

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## Chapter 1—Some of the Best Creative Tax Planning Techniques for Trusts©

### Schedule 1

#### Gomer Gonetotexas

**Hypothetical Technique #1 - Scenario B: 3.0% Preferred Coupon Taxed Pro-Rata; California Complex Trust Owns Preferred; Bequeaths Estate to Family (assumes \$3.3mm inflation adjusted estate tax exemption available in 20 years)**

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|--|-------------|
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| Rate of Return Taxed at Ordinary Rates             | 3.00%       |
| Rate of Return Taxed at Capital Gains Rates        | 4.40%       |
| Turnover Rate (% of Capital Gains Recognized/Year) | 30.00%      |
| Annual Consumption (increasing 2.5% per year)      | \$500,000   |
| Gift to Texas GST Tax Exempt Grantor Trust         | \$5,430,000 |

| <b>Assumptions - Income Taxes:</b>               |             |
|--|-------------|
| Long-Term Capital Gains and Health Care Tax Rate | 33.03%      |
| Ordinary Income and Health Care Tax Rate         | 52.63%      |
| <b>Assumptions - Family Limited Partnership:</b> |             |
| FLP Preferred Interest                           | \$4,000,000 |
| FLP Preferred Coupon                             | 3.00%       |
| FLP Valuation Discount                           | 35.00%      |
| <b>Assumptions - Other:</b>                      |             |
| 3rd Party Note Interest Rate                     | 3.00%       |

#### California Complex Trust

|         | California Complex Trust           |        |        |                             |                |                           |              |                              |
|---------|------------------------------------|--------|--------|-----------------------------|----------------|---------------------------|--------------|------------------------------|
|         | Beginning of Year Financial Assets | Income | Growth | FLP Preferred Distributions | FLP Terminates | Beneficiary Distributions | Income Taxes | End of Year Financial Assets |
| Year 1  | -                                  | -      | -      | 120,000                     | -              | -                         | (55,973)     | 64,027                       |
| Year 2  | 64,027                             | 1,921  | 2,817  | 120,000                     | -              | -                         | (54,524)     | 134,241                      |
| Year 3  | 134,241                            | 4,027  | 5,907  | 120,000                     | -              | -                         | (54,782)     | 209,393                      |
| Year 4  | 209,393                            | 6,282  | 9,213  | 120,000                     | -              | -                         | (55,896)     | 288,992                      |
| Year 5  | 288,992                            | 8,670  | 12,716 | 120,000                     | -              | -                         | (57,532)     | 372,845                      |
| Year 6  | 372,845                            | 11,185 | 16,405 | 120,000                     | -              | -                         | (59,525)     | 460,911                      |
| Year 7  | 460,911                            | 13,827 | 20,280 | 120,000                     | -              | -                         | (61,789)     | 553,229                      |
| Year 8  | 553,229                            | 16,597 | 24,342 | 120,000                     | -              | -                         | (64,273)     | 649,896                      |
| Year 9  | 649,896                            | 19,497 | 28,595 | 120,000                     | -              | -                         | (66,946)     | 751,042                      |
| Year 10 | 751,042                            | 22,531 | 33,046 | 120,000                     | -              | -                         | (69,793)     | 856,827                      |
| Year 11 | 856,827                            | 25,705 | 37,700 | 120,000                     | -              | -                         | (72,802)     | 967,429                      |
| Year 12 | 967,429                            | 29,023 | 42,567 | 120,000                     | -              | -                         | (75,972)     | 1,083,048                    |
| Year 13 | 1,083,048                          | 32,491 | 47,654 | 120,000                     | -              | -                         | (79,299)     | 1,203,894                    |
| Year 14 | 1,203,894                          | 36,117 | 52,971 | 120,000                     | -              | -                         | (82,788)     | 1,330,194                    |
| Year 15 | 1,330,194                          | 39,906 | 58,529 | 120,000                     | -              | -                         | (86,441)     | 1,462,188                    |
| Year 16 | 1,462,188                          | 43,866 | 64,336 | 120,000                     | -              | -                         | (90,263)     | 1,600,127                    |
| Year 17 | 1,600,127                          | 48,004 | 70,406 | 120,000                     | -              | -                         | (94,260)     | 1,744,277                    |
| Year 18 | 1,744,277                          | 52,328 | 76,748 | 120,000                     | -              | -                         | (98,439)     | 1,894,915                    |
| Year 19 | 1,894,915                          | 56,847 | 83,376 | 120,000                     | -              | -                         | (102,807)    | 2,052,331                    |
| Year 20 | 2,052,331                          | 61,570 | 90,303 | 120,000                     | 4,000,000      | -                         | (159,804)    | 6,164,400                    |

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## Chapter 1—Some of the Best Creative Tax Planning Techniques for Trusts©

### Schedule 1

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| Turnover Rate (% of Capital Gains Recognized/Year) | 30.00%      |
| Annual Consumption (increasing 2.5% per year)      | \$500,000   |
| Gift to Texas GST Tax Exempt Grantor Trust         | \$5,430,000 |

| <b>Assumptions - Income Taxes:</b>               |                   |              |
|--|-------------------|--------------|
|  | <b>California</b> | <b>Texas</b> |
| Long-Term Capital Gains and Health Care Tax Rate | 33.03%            | 25.00%       |
| Ordinary Income and Health Care Tax Rate         | 52.63%            | 44.60%       |
| <b>Assumptions - Family Limited Partnership:</b> |                   |              |
| FLP Preferred Interest                           |                   | \$4,000,000  |
| FLP Preferred Coupon                             |                   | 3.00%        |
| FLP Valuation Discount                           |                   | 35.00%       |
| <b>Assumptions - Other:</b>                      |                   |              |
| 3rd Party Note Interest Rate                     |                   | 3.00%        |

#### Texas GST Tax Exempt Grantor Trust

|         | <b>Beginning of Year Financial Assets</b> | <b>Income</b> | <b>Growth</b> | <b>FLP Growth Distributions</b> | <b>Asset Purchase Proceeds</b> | <b>Beneficiary Distributions</b> | <b>Income Taxes</b> | <b>End of Year Financial Assets</b> |
|---------|---|---------------|---------------|---------------------------------|--------------------------------|----------------------------------|---------------------|-------------------------------------|
| Year 1  | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 2  | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 3  | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 4  | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 5  | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 6  | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 7  | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 8  | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 9  | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 10 | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 11 | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 12 | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 13 | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 14 | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 15 | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 16 | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 17 | -   | -             | -             | -                               | -                              | -                                | -                   | -                                   |
| Year 18 | -   | -             | -             | -                               | 16,800,472                     | -                                | -                   | 16,800,472                          |
| Year 19 | 16,800,472                                | 504,014       | 739,221       | -                               | -                              | -                                | -                   | 18,043,706                          |
| Year 20 | 18,043,706                                | 541,311       | 793,923       | -                               | -                              | -                                | -                   | 19,378,941                          |

Download large-format schedules here: [https://oregonstatebar.s3-us-west-2.amazonaws.com/Seminars/2020/OTI20\\_Chapter\\_1\\_Schedules.pdf](https://oregonstatebar.s3-us-west-2.amazonaws.com/Seminars/2020/OTI20_Chapter_1_Schedules.pdf)

## Schedule 1

### Gomer Gonetotexas

**Hypothetical Technique #1 - Scenario B: 3.0% Preferred Coupon Taxed Pro-Rata; California Complex Trust Owns Preferred; Bequeaths Estate to Family (assumes \$3.3mm inflation adjusted estate tax exemption available in 20 years)**

This is a hypothetical illustration of mathematical principles and is not a prediction or projection of performance of an investment or investment strategy.

This material is based on the assumptions stated herein. In the event any of the assumptions used do not prove to be true, results are likely to vary substantially from the examples shown herein. These examples are for illustrative purposes only and no representation is being made that any client will or is likely to achieve the results shown.

| <b>Assumptions:</b>                                |             |
|--|-------------|
| Total Estimated Rate of Return - Financial Assets  | 7.40%       |
| Rate of Return Taxed at Ordinary Rates             | 3.00%       |
| Rate of Return Taxed at Capital Gains Rates        | 4.40%       |
| Turnover Rate (% of Capital Gains Recognized/Year) | 30.00%      |
| Annual Consumption (increasing 2.5% per year)      | \$500,000   |
| Gift to Texas GST Tax Exempt Grantor Trust         | \$5,430,000 |

| <b>Assumptions - Income Taxes:</b>               |                   |              |
|--|-------------------|--------------|
|  | <b>California</b> | <b>Texas</b> |
| Long-Term Capital Gains and Health Care Tax Rate | 33.03%            | 25.00%       |
| Ordinary Income and Health Care Tax Rate         | 52.63%            | 44.60%       |
| <b>Assumptions - Family Limited Partnership:</b> |                   |              |
| FLP Preferred Interest                           | \$4,000,000       |              |
| FLP Preferred Coupon                             | 3.00%             |              |
| FLP Valuation Discount                           | 35.00%            |              |
| <b>Assumptions - Other:</b>                      |                   |              |
| 3rd Party Note Interest Rate                     | 3.00%             |              |

### Note Between Gomer Gonetotexas and 3rd Party Lender

|         | Beginning<br>of Year<br>Principal | Interest | Note<br>Payments | End of Year<br>Principal |
|---------|-----------------------------------|----------|------------------|--------------------------|
| Year 1  | -                                 | -        | -                | -                        |
| Year 2  | -                                 | -        | -                | -                        |
| Year 3  | -                                 | -        | -                | -                        |
| Year 4  | -                                 | -        | -                | -                        |
| Year 5  | -                                 | -        | -                | -                        |
| Year 6  | -                                 | -        | -                | -                        |
| Year 7  | -                                 | -        | -                | -                        |
| Year 8  | -                                 | -        | -                | -                        |
| Year 9  | -                                 | -        | -                | -                        |
| Year 10 | -                                 | -        | -                | -                        |
| Year 11 | -                                 | -        | -                | -                        |
| Year 12 | -                                 | -        | -                | -                        |
| Year 13 | -                                 | -        | -                | -                        |
| Year 14 | -                                 | -        | -                | -                        |
| Year 15 | -                                 | -        | -                | -                        |
| Year 16 | -                                 | -        | -                | -                        |
| Year 17 | -                                 | -        | -                | -                        |
| Year 18 | 16,800,472                        | 504,014  | (504,014)        | 16,800,472               |
| Year 19 | 16,800,472                        | 504,014  | (504,014)        | 16,800,472               |
| Year 20 | 16,800,472                        | 504,014  | (17,304,486)     | -                        |

Download large-format schedules here: [https://oregonstatebar.s3-us-west-2.amazonaws.com/Seminars/2020/OTI20\\_Chapter\\_1\\_Schedules.pdf](https://oregonstatebar.s3-us-west-2.amazonaws.com/Seminars/2020/OTI20_Chapter_1_Schedules.pdf)





Private Wealth Management

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## Some of the Best Creative Tax Planning Techniques for Trusts

### Important Information

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Goldman Sachs does not provide legal, tax or accounting advice. Clients of Goldman Sachs should obtain their own independent tax and legal advice based on their particular circumstances.

The information herein is provided solely to educate on a variety of topics, including wealth planning, tax considerations, estate, gift and philanthropic planning.

**The Primary Importance of Goals-Based Planning for the Successful Succession of the Family Wealth Irrespective of the Status of the Tax Law (Pages 1-4 of the Paper)**

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- The importance of first determining a client's goals that determine the estate plan's essential strategies.
- Once the purpose and use of the family's capital has been determined, trust planning strategies should be developed to maximize the investment risk-adjusted, after-tax wealth that may be applied to those purposes and uses.
  - Planning almost always begins with the use of trusts.
  - There are trust planning strategies that reduce both the income taxes on capital and its income and the transfer taxes on capital.
  - Trust planning for those two taxes does not have to be, and should not be, an "either or" exercise. The purpose of this lecture is to discuss some of the most creative trust planning strategies that reduce both taxes.

2

**Sometimes the Strategies Involve More Than One Type of Trust So This Lecture Begins With a Brief Discussion of Each Type of Trust: Non-Grantor Trusts, Grantor Trusts, Spousal Grantor Trusts and Beneficiary Deemed Owned Trusts (Pages 4-6 of the Paper)**

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- Non-Grantor Trusts.
  - Non-grantor trusts are treated as separate taxpayers.
  - Non-grantor trusts are currently taxed in 2020 at the highest rate when the taxable income exceeds \$12,950.
  - However, non grantor trusts enjoy deductions from taxable income for amounts required to be distributed to the trust beneficiaries or are properly paid or credited to them.
  - A corresponding amount of income is included in the gross income of the beneficiaries.
  - With respect to charitable beneficiaries of a non grantor trust, the non grantor trust can receive a deduction for amounts of gross income paid for charitable purposes.

3

**Sometimes the Strategies Involve More Than One Type of Trust So This Lecture  
Begins With a Brief Discussion of Each Type of Trust: Non-Grantor Trusts, Grantor  
Trusts, Spousal Grantor Trusts and Beneficiary Deemed Owned Trusts (Continued)**

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▪ **Grantor Trusts.**

- The grantor of a trust may be treated as the deemed owner for income tax purposes of all or a portion of the trust if certain provisions exist in the trust document.
- These provisions may not cause the trust assets to be included in the grantor's estate for estate tax purposes.
- The IRS has conceded that the payment of income taxes on the income of a grantor trust is not a gift to the trust beneficiaries.

4

**Sometimes the Strategies Involve More Than One Type of Trust So This Lecture  
Begins With a Brief Discussion of Each Type of Trust: Non-Grantor Trusts, Grantor  
Trusts, Spousal Grantor Trusts and Beneficiary Deemed Owned Trusts (Continued)**

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▪ **Spousal Grantor Trusts.**

- A spousal grantor trust is a trust in which the deemed income tax owner is the spouse of the beneficiary.
- A transaction between the beneficiary of the spousal grantor trust and the spousal grantor trust is treated as a transaction between the beneficiary and his or her spouse.
- A transfer between spouses is treated as a non-recognition event for income tax purposes.
- The beneficiary spouse could sell assets to the spousal grantor trust without any capital gains consequences.
- Any assets the beneficiary spouse sells for adequate and full consideration will not be included in the spousal beneficiary's estate.

5

**Sometimes the Strategies Involve More Than One Type of Trust So This Lecture  
Begins With a Brief Discussion of Each Type of Trust: Non-Grantor Trusts, Grantor  
Trusts, Spousal Grantor Trusts and Beneficiary Deemed Owned Trusts (Continued)**

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▪ **Beneficiary Defective Owned Trusts.**

- Beneficiary defective owned trusts are trusts in which the deemed owner of the trust assets for income tax purposes is the beneficiary of the trust because IRC Section 678 applies.
- There are three methods where IRC Section 678 can apply to a trust.
- In each of these methods the trust cannot have provisions that would make the trust a grantor trust.

6

**Sometimes the Strategies Involve More Than One Type of Trust So This Lecture  
Begins With a Brief Discussion of Each Type of Trust: Non-Grantor Trusts, Grantor  
Trusts, Spousal Grantor Trusts and Beneficiary Deemed Owned Trusts (Continued)**

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▪ **IRC Section 678(a)(1) application.**

- A beneficiary is the deemed income tax owner of any portion of a trust in which the beneficiary has a power “exercisable solely by himself to vest corpus or income of that portion in himself, herself or itself.”
- For purposes of this lecture, these trusts will be referred to as “beneficiary defective owned trusts” or “BDOTs.”

7

**Sometimes the Strategies Involve More Than One Type of Trust So This Lecture  
Begins With a Brief Discussion of Each Type of Trust: Non-Grantor Trusts, Grantor  
Trusts, Spousal Grantor Trusts and Beneficiary Deemed Owned Trusts (Continued)**

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- IRC Section 678(a)(2) application.
  - A beneficiary is the deemed income tax owner of any portion of a trust in which that person has “previously partially released or otherwise modified” an IRC Section 678(a)(1) vesting power and retains control that would cause the grantor to be treated as the trust owner.
  - For purposes of this lecture, these trusts will be referred to as “beneficiary defective heirloom’s trusts” or “BDITs.”

8

**Sometimes the Strategies Involve More Than One Type of Trust So This Lecture  
Begins With a Brief Discussion of Each Type of Trust: Non-Grantor Trusts, Grantor  
Trusts, Spousal Grantor Trusts and Beneficiary Deemed Owned Trusts (Continued)**

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- IRC Section 678 application because of operation of IRC Section 1361(d)(3) with respect to a subchapter S corporation.
  - With respect to stock of a subchapter S corporation owned by a trust, if the requirements of IRC Section 1361(d)(3) are met, the income beneficiary of a trust that holds subchapter S stock will be considered the deemed income tax owner of that subchapter S stock.
  - Such a trust will be referred to as a qualified subchapter S trust or a “QSST.”

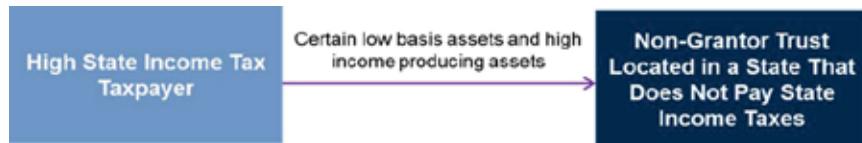
9

**Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts**  
(Pages 6-47 of the Paper)

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- Using non-grantor trusts to reduce state income taxes and to reduce or avoid certain federal income taxes.



10

**Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)**

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- Advantages of the technique.
  - Substantial state income taxes could be saved.
  - The taxpayer using his or her increased gift tax exemptions could create a non-grantor trust in a state that does not tax that trust income, which could save income taxes and transfer taxes.
  - A non-grantor trust used for these purposes could be created without paying gift taxes: by the use of the taxpayer's exemption; by creating a trust that is incomplete for gift tax purposes; or by creating a charitable deduction trust that qualifies as a QTIP trust and is designed to be a non-grantor trust with respect to the principal or capital gains earnings of the QTIP trust.

11

### Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

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- The IRC Section 643(f) considerations of the technique.
  - IRC Section 643(f) provides that when two or more trusts that have substantially the same primary beneficiaries or beneficiaries, and a principal purpose of such trusts is the avoidance of income tax, that the trusts will be treated as one trust for income tax purposes.
  - The final regulations backed off of the proposition that just because the trusts save income taxes it does not necessarily mean the principal purpose of such trusts is avoidance of income taxes.

12

### Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

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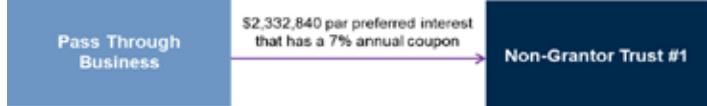
- Non-grantor trusts may have the ability to increase IRC Section 199A deduction thresholds.
  - What is an IRC Section 199A deduction and how does it work?
    - What is it?
      - New deduction for domestic qualified business income ("QBI") as part of the Tax Cuts and Jobs Act of 2017 ("TCJA") signed into law December 22, 2017.
    - How much is it worth?
      - At most, the deduction could be up to 20% of QBI (i.e., the deduction could make a 37% ordinary rate 29.6%).
      - A taxpayer; IRC Section 199A deduction is the lesser of (i) a taxpayers "combined qualified income amount" or (ii) 20% of the excess, if any, of the taxpayers taxable income or for the taxable year, less the taxpayer's net capital gain.

13

**Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)**

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- Consider the following technique.



```
graph LR; A[Pass Through Business] -- "$2,332,840 per preferred interest that has a 7% annual coupon" --> B[Non-Grantor Trust #1]
```

- The coupon rate on the preferred interest could be designed to increase at the same percentage rate as the 32% bracket increases.

14

**Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)**

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- Advantages of the technique.
  - The technique lowers the family's income taxes associated with the family business.
  - There could be multiple non-grantor trusts, subject to the IRC Section 643(f) consideration.
  - For many families there should not be any gift taxes associated with the gifts to the non-grantor trusts, either because of the increased exemption, or because the non-grantor trusts are designed to be an incomplete gift (a so-called "ING trust").
  - Because of Revenue Ruling 83-120, if a preferred interest is used, the yield can be relatively high in comparison to the then prevailing interest rates, without causing gift tax consequences.

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**Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)**

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- Considerations of the preferred interest technique with respect to increasing the IRC Section 199A benefit.
  - IRC 643(f) considerations.
  - The regulations under IRC Section 199A provide an anti-abuse rule that a trust, if it is formed with a purpose of avoiding the threshold amount or of using more than one threshold amount, the trust will not be respected as a separate entity for purposes of determining the threshold amount. Other purposes must be found.

16

**Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)**

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- Non-grantor trusts may have the ability to mitigate the SALT limitation. For income tax years 2018 to 2025, the aggregate amount of state and local real property taxes, personal property taxes, and state and local income taxes may not exceed \$10,000 or \$5,000 in the case of a married person filing separately.
  - Please see an example of the technique below.

The diagram illustrates a tax planning technique. On the left, a large blue box is labeled "Grantor". Four arrows point from this box to four separate dark blue boxes, each labeled "Non-Grantor Trust #1", "Non-Grantor Trust #2", "Non-Grantor Trust #3", and "Non-Grantor Trust #4". Each trust box contains a purple arrow pointing to a detailed description of a 1/4 interest in a vacation home, specifying property taxes and ordinary income requirements.

Grantor

Non-Grantor Trust #1

Non-Grantor Trust #2

Non-Grantor Trust #3

Non-Grantor Trust #4

Undivided 1/4 interest in vacation home with that 1/4 interest being assessed \$10,000 in property taxes plus properties that earn at least \$10,000 in ordinary income

Undivided 1/4 interest in vacation home with that 1/4 interest being assessed \$10,000 in property taxes plus properties that earn at least \$10,000 in ordinary income

Undivided 1/4 interest in vacation home with that 1/4 interest being assessed \$10,000 in property taxes plus properties that earn at least \$10,000 in ordinary income

Undivided 1/4 interest in vacation home with that 1/4 interest being assessed \$10,000 in property taxes plus properties that earn at least \$10,000 in ordinary income

17

**Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)**

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- Advantages of the technique.
  - This technique has the same advantages as using non-grantor trusts to save state income taxes.
  - For many taxpayers, the complexity of creating an ING trust may not be necessary.
  - The object of this technique is to save federal income taxes, not state income taxes. Assuming the taxable income of the trusts is around \$10,000, the state income tax issues should be insignificant.

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**Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)**

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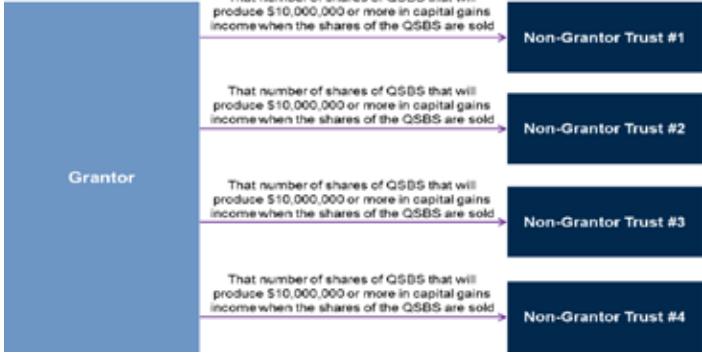
- Considerations of the technique.
  - IRC Section 643(f) consideration.

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**Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)**

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- Non-grantor trusts could expand the sale of qualified small business stock (QSBS) from capital gains treatment.
  - An owner of shares of QSBS, as defined in IRC Section 1202(c), could give shares of his QSBS stock to multiple non-grantor trusts in order to receive multiple \$10,000,000 deductions under IRC Section 1202(b)(1)(A) from the capital gains tax for the collective sale of that stock.
  - Please see an example of the technique below:



The diagram illustrates a tax planning technique. On the left, a large blue box is labeled "Grantor". Four arrows point from the "Grantor" box to four separate dark blue boxes, each labeled "Non-Grantor Trust #1", "Non-Grantor Trust #2", "Non-Grantor Trust #3", and "Non-Grantor Trust #4". Above each trust box, a purple text box contains the same text: "That number of shares of QSBS that will produce \$10,000,000 or more in capital gains income when the shares of the QSBS are sold".

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**Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)**

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- Additional advantages and a consideration of the technique.
  - Additional advantages of the technique.
    - This technique has the same advantages as using non-grantor trusts to save state income taxes.
  - Additional consideration of the technique.
    - IRC Section 643(f) consideration.

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### Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

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- Non-grantor trust beneficiaries, who live in a state with a high income tax, can have the beneficial use of the non-grantor trust assets and may avoid or reduce income taxes associated with that use.
  - Non-grantor trusts can be designed to not be subject to state income taxes of a high tax state if the resident trust requirements of the high tax state do not apply.
    - The rules determining which state (or states) will assert jurisdiction to tax a trust's undistributed income are complex and vary from state to state. More than one state may assert the right to tax all or part of such income.
    - One or more of the residence of the trust creator, the residence of the beneficiaries, the residence of the trustees, the location of trust assets, the source of trust income and the trust's principal place of administration may be predicates for taxation.
    - A state's general rule may have exceptions, and exceptions to the exceptions. For example, in general a trust created by a New York resident or decedent is subject to New York income tax. There is an exception for a trust with no New York trustees and no assets located in or income sourced to New York. There is an exception to the exception for a trust that is an "ING" trust, a non-grantor trust that is an incomplete gift for federal purposes, which is treated as a grantor trust for New York purposes.
    - In *North Carolina v. Kaestner Family Trust*, the U.S. Supreme Court held unconstitutional a North Carolina statute taxing undistributed trust income solely on the basis of a beneficiary's residence in North Carolina.
  - There are circumstances in which non-grantor trust beneficiaries, who live in a high tax state, can receive tax free benefits of that trust located in a low tax state.
    - The trustee might give beneficiaries the free use of trust assets such as a residence.
    - The trustee could make loans to the beneficiaries on very favorable terms.

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### Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

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- The technique of distributing low basis property intended for sale in the near term from a low tax state trust to the high tax state beneficiary in a manner whereby the beneficiary could sell the distributed property without paying any state and federal taxes.
  - IRC Section 643(e)(3) allows a trustee to elect to recognize gain on the distribution of property to the beneficiary.
  - The distribution of property may carry out trust income to the beneficiary, if that distribution carries out D.N.I. The election may increase the DNI carried out to the beneficiary because the fair market value of the distributed property, rather than its basis, will be used for purposes of determining the amount distributed. However, if capital gains are not otherwise included in the trust's DNI, the gain recognized by the trust on the distribution may not itself be included in the trust's DNI, thereby giving the beneficiary in a high tax state increased basis without subjecting the gain to state tax at the beneficiary's rate.

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### Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

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- The low tax state non-grantor trust could contribute its assets to a subchapter S corporation and make distributions to beneficiaries who reside in certain high tax states on a tax free basis.
  - The trustee of the low tax state non-grantor trust could contribute assets to a subchapter S corporation and make an election to be taxed as an Electing Small Business Trust ("ESBT").
    - If the trust is an ESBT and owns only the subchapter S corporation, trust income is excluded from D.N.I. and is taxed at the highest federal rates without a distribution deduction, regardless of distributions actually made.
    - Any distributions from the ESBT to beneficiaries who reside in a high tax state will be received income tax free, if the beneficiary's state follows the ESBT rules.
    - Income taxed to the trust will be subject to state tax at the rate of the low tax state. If the ESBT owns assets outside the subchapter S corporation, it is treated for income tax purposes as two separate trusts, and the rules stated in this paragraph apply separately to the S portion of the trust.
  - A consideration of the technique is that highest federal tax rate applies on ordinary income, but the ESBT will have the benefit of lower capital gains rates on realized capital gains and qualified dividend income.
  - Another consideration is that not all states follow the federal ESBT rules in all circumstances.

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### Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

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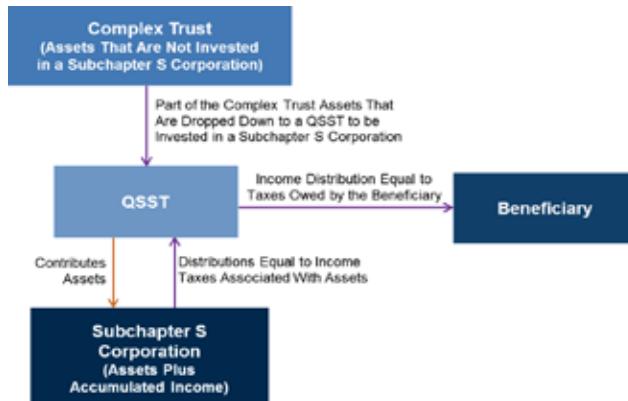
- Non-grantor trust income in a low tax state could be trapped by making distributions to another trust located in a low tax state before it is distributed to a beneficiary who lives in a high tax state.
  - Assume a discretionary trust has the power to make distributions to not only a beneficiary but also a trust for a beneficiary.
  - Assume in year one the discretionary trust, located in a low tax state ("Trust 1"), allocates its income to a trust, which is also located in a low tax state ("Trust 2"), for a beneficiary. Trust 2 will pay income tax on that distributed income.
  - In year two, at the beginning of the year, the assets in Trust 2 could be distributed to the beneficiary who resides in the high tax state.
  - The high tax state beneficiary will only pay income tax on the income earned by Trust 2 in year two.

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**Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)**

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- Taxing a non-grantor trust at the beneficiary's low individual income tax rate without making distributions, on a net basis, to the beneficiary.
  - The technique is illustrated below:



The diagram shows the flow of assets and income between three entities:

- Complex Trust (Assets That Are Not Invested in a Subchapter S Corporation)**: This entity drops assets into a **QSST**.
- QSST**: This entity receives assets from the Complex Trust and makes an **Income Distribution Equal to Taxes Owed by the Beneficiary** to the **Beneficiary**.
- Subchapter S Corporation (Assets Plus Accumulated Income)**: This entity receives assets from the QSST and makes **Distributions Equal to Income Taxes Associated With Assets** to the QSST.

**Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)**

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- Advantages of the technique.
  - If only an amount equal to the income taxes the beneficiary must pay is distributed by the S corporation to the QSST, on a net basis, the beneficiary will not receive any cash that could be spent, bequeathed or transferred in a manner the grantor of the complex trust did not intend.
  - The beneficiary may be in a lower tax bracket than the trust. The taxes associated with the beneficiary being the deemed owner of the QSST may equal the cash distributed by the QSST to the beneficiary, which will limit any cash build up in the beneficiary's estate.
  - If the subchapter S corporation participates in a trade or business, and if the current beneficiary of the QSST materially participates in that trade or business, or is in a lower marginal bracket, significant taxes under Section 1411 may be saved with the technique.
  - The trust is much more flexible than a simple income only trust and may be administered to simulate a complex trust without the income tax and health care tax disadvantages of a complex trust.
  - The transfer tax advantage of this technique is that it preserves whatever inherent transfer tax advantage the trust has without distributing net cash assets from the trust to beneficiaries.

Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

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- Considerations of the technique.
  - The federal income tax considerations with utilizing a subchapter S corporation.
    - If future generations wish to terminate a subchapter S corporation, there may be immediate capital gains consequences in comparison to the assets being held in a partnership or FLLC.
    - If the assets owned by the subchapter S corporation are sold immediately after, or before, the termination, that capital gains comparative disadvantage to a partnership organization may be mitigated.
    - That inside basis disadvantage may also be mitigated by the use of drop-down partnerships and leverage strategies.
  - Any income of the QSST that does not accrue from subchapter S stock earnings will be taxed under normal subchapter J rules.
  - State income tax considerations.

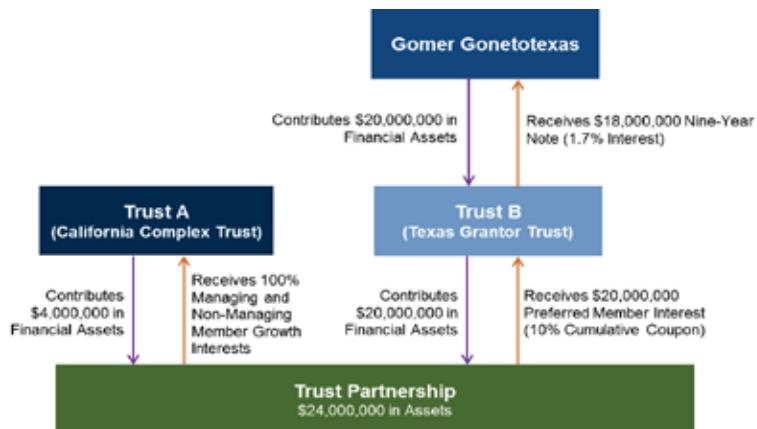
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Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

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- Using two class partnerships to shift income of a non-grantor trust residing in a high state income tax state to a low state income tax state.
  - The technique is illustrated below:



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**Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)**

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- Seventeen years after the creation of the two class partnership, Gomer borrows cash from third party lender and buys Trust B's preferred interest in the trust partnership for its fair market value.
  - The technique is illustrated below:

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**Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)**

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- State income tax and transfer tax advantage.
  - Significant state income taxes and the investment opportunity costs associated with those state income taxes can be saved with this technique.
  - The trustee of Trust B may wish to use some of its positive cash flow from the transaction to purchase life insurance on the life of Gomer Gonetotexas, at least to the extent there may be estate taxes associated with Gomer's note.
    - The insurance could serve as a hedge to Gomer's early death.
  - The trustee of the complex trust does not have to distribute assets or cash to a beneficiary, or give a withdrawal right to a beneficiary, in order to save income taxes or health care taxes.
  - If the two trusts have identical provisions the valuation rules under IRC Section 2701 may not apply.

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Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

Private  
Wealth  
Management



- Considerations of the technique.
  - A party may not exist that could create a grantor trust that could invest and receive a preferred partnership interest.
  - The technique is complex.
  - In certain circumstances it may be more profitable for the old trust to sell the high basis assets to the new trust for a low interest (AFR Rate) note to the new trust.
  - The IRS may argue that the valuation rules of IRC Section 2701 apply despite the identical provisions and beneficial interests of the two trusts.
  - If there is not a buy-back of the preferred interest by the grantor of the new grantor trust before the death of the grantor much of the income tax benefit will be lost because of the lack of step-up that accrues for the assets held in the new grantor trust.

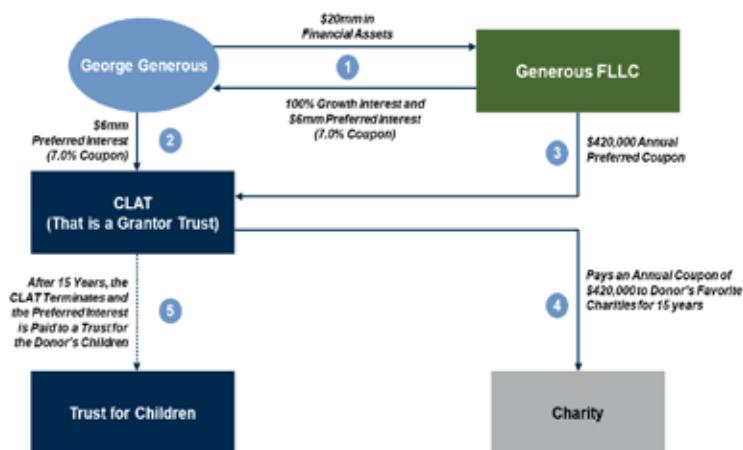
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Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

Private  
Wealth  
Management



- The use of a high-yield preferred partnership or membership interest with a charitable lead annuity trust ("CLAT") to make distributions to a contributor's favorite charities.
  - The technique is illustrated below:



33

### Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

Private  
Wealth  
Management



- Advantages of the technique.
  - The donor will not pay income taxes or healthcare taxes on income that is allocated to the CLAT, if the CLAT is a conventional CLAT and is not a grantor trust.
  - The donor will receive an upfront deduction against income taxes for the actuarial value of the annuity interest paid to charity if the CLAT is a grantor trust.
  - Income tax valuation advantage: IRS concedes preferred partnership interests should have a high coupon.
  - IRC Section 2036 avoidance advantage, if George gives or sells the growth interests to his family.

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### Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

Private  
Wealth  
Management



- Considerations of the technique.
  - The partial interest rule should not apply for gift tax purposes or income tax purposes (if a grantor CLAT is used), but the IRS may make the argument.
  - The partial interest rule, if it has applications at all, may be avoided if the taxpayer in the early years is the only owner of the preferred and his family at least partially owns the growth interest. After a few years, the taxpayer could give his preferred interest to the CLAT. Rev. Rul. 86-60, 1986-1 C.B. 302 said the partial interest rule did not apply if there was a four year delay between a possible partial interest creation and the gift to charity.
  - Care should be taken to make sure that there is not a tax on excess business holdings under IRC Section 4943.
  - If the CLAT is a grantor trust the grantor will pay the income taxes on the earnings of the CLAT.
    - However, from a transfer tax planning point of view, that is generally advantageous.

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### Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

Private  
Wealth  
Management



- Creation of a non-grantor trust that is not a completed gift for gift tax purposes (“ING” trust).
  - There can be numerous income tax advantages associated with non-grantor trusts.
  - Non-grantor trusts in which there is a completed gift have certain considerations that a non-grantor trust that is not a completed gift for gift tax purposes does not have.
    - The creation of the trust will use the grantor's exemption and/or result in gift taxes unless a marital deduction is available.
    - In order to be a completed gift the grantor must release dominion and control and generally may not have a beneficial interest.
  - Designing a trust that is an ING trust for gift tax purposes, but is a non-grantor trust for income tax purposes is difficult.
    - Currently, a popular design of such a trust provides that the trust will be irrevocable; during the existence of the trust all distributions of income and principal may be made by the trustee to the grantor and/or the grantor's issue, but solely at the direction of a distribution committee; the distribution committee consists of the grantor and several of his issue and functions in a non-fiduciary capacity; decisions of the distribution committee may be executed either by the grantor and a majority of the other members of the distribution committee, or unanimously by all members other than the grantor; the grantor retains a power of appointment over the remainder of the trust; and the grantor retains the sole power to make trust distributions from trust principal under a reasonably definite standard for the health, education and support of his issue.

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### Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

Private  
Wealth  
Management



- The grantor of the ING trust must not retain controls that trigger grantor trust status.
  - The power to control beneficial enjoyment under IRC Section 674, the power to revoke the trust and reinvest trust property under IRC Section 676, and the power to distribute income for the benefit of the grantor or the grantor's spouse under IRC Section 677, even if held by the grantor, will not trigger grantor trust status if the grantor's power is only exercisable with an adverse party's approval.
  - The presence of an adverse party does not prevent the application of IRC Section 673 to make a trust a grantor trust.
    - IRC Section 673 provides for grantor trust treatment, if the settlor of a trust holds a reversionary interest in income or principal worth more than 5% of the trust's value at its inception. IRC Section 673(c) provides that discretionary powers should be assumed to be exercised to maximize the value in favor of the grantor “in determining whether a reversionary interest has a value in excess of 5%.”
    - However, until recently, this statutory language has not been interpreted to suggest that a discretionary exercise in favor of the grantor can be assumed in determining whether a reversion actually exists. While the term reversion is not defined in the statute, it has traditionally been defined by the IRS as the interest remaining with the owner of a vested estate upon transferring a lesser vested estate to another person. Under this definition, if a grantor has transferred his entire interest, and not a lesser interest, then IRC Section 673 should not apply even if the grantor could receive a distribution of trust property as a result of discretionary actions of others, whether or not those others are adverse parties. However, in PLR 201642019, the IRS revoked part of PLR 201426014 and held that under IRC Section 673(c), the subject trust was a grantor trust, because members could resign from a distribution committee, which under the terms of the trust would cause the trust to terminate and revert to the grantor. An IRC Section 673(c) “fix” for this IRS position might be to draft the trust to provide if such resignations occurred, the ING trust would continue without providing the trustee with any discretion to make distributions to the grantor.

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### Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

Private  
Wealth  
Management



- The ING trust also needs to be designed in a manner where certain retained powers by the grantor exist which will make the trust incomplete for gift tax purposes, but those retained powers must not make the trust a grantor trust.
  - The grantor needs to retain a testamentary power of appointment over the remainder beneficiary interests of the trust.
  - The grantor needs to also have powers that make the grantor's transfer to the trust incomplete for its current beneficiary interests.
    - The grantor could have a retained power under which distributions could only be made from the trust with the consent of the grantor and the majority of a distribution committee.
    - The grantor could retain the sole power to make trust distributions from trust principal for the health, education, maintenance and support of his descendants.

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### Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

Private  
Wealth  
Management



- Distribution committee members of an ING trust should avoid having a general power of appointment with the distribution powers that they have.
  - The statutory exception under IRC Section 2514(c)(3)(A) and (B) could apply to avoid gift tax consequences for distribution committee members when a distribution is made to a beneficiary other than that committee member.

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### Some of the Best Creative Tax Planning Ideas for Non-Grantor Trusts (Continued)

Private  
Wealth  
Management



- Consideration: A state could interpret IRC Sections 671-677 differently than the IRS does, so that one or more of IRC Sections 671-677 apply to make the trust a grantor trust for state law purposes, or the state law could be inconsistent with federal law.
  - For instance, a state may interpret IRC Section 673(c), or IRC Section 677, differently than the IRS does.
  - State grantor trust statutes could operate differently in that state than the Internal Revenue Code does.
- The overall cumulative federal revenue considerations of the techniques may lead Treasury to be more aggressive in protecting federal revenues.

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### Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Pages 47-133 of the Paper)

Private  
Wealth  
Management



- Conventional uses of grantor trust status.
  - Gift tax free payment of income tax.
    - Mismatch between gift and estate tax completion and income tax ownership.
      - The opportunity to shift wealth through the grantor's payment of income taxes on grantor trust income arises because of a mismatch between the grantor trust rules, on the one hand, and the rules governing gift completion and gross estate inclusion, for gift and estate tax purposes, on the other. In particular, it is possible for a grantor to make a completed gift to a trust that will pass outside of the grantor's gross estate for estate tax purposes, yet still cause the trust to be treated as owned by the grantor for income tax purposes.
    - IRS position on payment of income tax. In Rev. Rul. 2004-64, the IRS conceded that the payment of income taxes on the income of a grantor trust is not a gift for gift tax purposes.

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Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Tax-free swapping out of low-basis assets.
  - Ensure full and adequate consideration.
  - IRS safe harbor or retained power of substitution for transfers of equivalent value.
  - IRS position that grantor activities with grantor trusts are also ignored.
    - The ability to swap assets tax free is made possible by the well-entrenched IRS position, set forth in Rev. Rul. 85-13, that a grantor trust is ignored for income tax purposes and does not "retain its vitality as a separate entity."
  - A grantor of a grantor trust, by the grantor swapping assets with the grantor trust, can create basis enhancing opportunities.

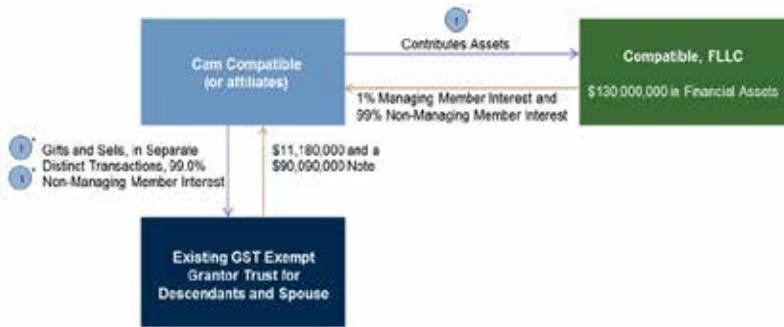
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Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Tax-free freeze transactions: the grantor sells to an intentionally defective trust ("SIDGT") technique.
  - The technique is illustrated below:



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

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**Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)**

Private  
Wealth  
Management



- Income tax and basis enhancing advantages of the SIDGT technique.
  - The ability to have sales to a grantor trust be ignored for income tax purposes.
  - The advantage of locating income tax inefficient asset classes inside a grantor trust that is not subject to estate taxes.

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**Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)**

Private  
Wealth  
Management



- Transfer tax advantages of the SIDGT technique.
  - Transfer tax advantage of transferring a non-managing interest.
  - The near term death of the grantor of a grantor trust generally does not affect the technique like the death of a grantor of a GRAT.
  - The appreciation of the assets of the trust above the interest of the note used in any sale to a grantor trust for the grantor's spouse will not be taxable in the grantor/seller's estate.

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### Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Flexibility advantages of the SIDGT.
  - Flexibility could be achieved by naming a spouse as a beneficiary of the grantor trust and giving a grantor's spouse a special power of appointment.
  - Flexibility could also be achieved by converting the note to a note with a different interest rate, a private annuity, purchasing assets owned by the trust and/or renouncing the powers that make the trust a grantor trust.
  - A donor, under the SIDGT technique (coupled with a transfer of an entity interest in which the donor has investment control), may retain investment control of the family's assets and may also retain limited control of any distributions from the transferred entity interests to family members, if that limited control is compliant with IRC Section 2036(a)(2).

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### Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Considerations of the SIDGT technique.
  - State income tax considerations.
  - The IRS could be successful in the argument, that because of the Step Transaction Doctrine, a valuation discount is not appropriate in valuing the transferred entity interest.
  - If the assets decrease in value, the gift tax exemption equivalent may not be recoverable.
  - There may be gain recognition considerations with respect to the note receivable or note payable that may exist with the grantor trust as the death of the donor.
  - There may be income realization considerations with respect to a note payable that may exist with the grantor trust at the death of the donor.
  - On the death of the grantor there will be no step-up in basis in the assets owned by the grantor trust.
  - The IRS may contest the valuation of any assets that are hard to value that are donated to a grantor trust or are sold to such a trust.
    - The problem and a probable solution: defined allocation transfers.

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**Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)**

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- Contribution of a leveraged LLC interest to a Grantor Trust (“LAIDGT”) technique.
  - The technique is illustrated below:

The diagram illustrates the LAIDGT technique. At the top, a blue box labeled "Cam Compatible (or affiliates)" has an arrow pointing to the right labeled "Contributes Assets" leading to a green box labeled "Compatible, FLLC" which contains "\$150,000,000 in Financial Assets". From the "Compatible, FLLC" box, an arrow points back to the "Cam Compatible (or affiliates)" box. Below this, two arrows point downwards from the "Cam Compatible (or affiliates)" box to two separate boxes: "Existing GST Exempt Grantor Trust for Descendants and Spouse" and "New GST Exempt Grantor Trust for Descendants and Spouse". The "Existing GST Exempt Grantor Trust" receives "0.01% Class A Managing Member Interest, 0.99% Class B Managing Member Interest, 99% Non-Managing Member Interest and \$135,000,000 Convertible Note"\*. The "New GST Exempt Grantor Trust" receives "0.99% Class B Managing Member Interest".

\* These transactions need to be separate, distinct and independent.  
 \*\* The retained note in the LAIDGT technique could be designed to (i) have a mandatory conversion of the amount of non-managing member interests that are equal in value to the principal balance of the note at the death of the holder of the note, and (ii) before death, at the election of the holder, the then outstanding principal of the note could be converted to that amount of non managing member interests that are equal in value to that outstanding principal or a private annuity.

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**Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)**

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- Income tax and basis enhancing advantages of the technique.
  - The LAIDGT has all of the income tax and basis enhancing advantages of the SIDGT technique and additional advantages that are unique to retaining a convertible note from a single member FLLC.
  - There is greater authority that a sale to a single member FLLC in the LAIDGT technique will be treated as a non-taxable sale to a disregarded entity for income tax purposes than there is for a sale to a grantor trust in the SIDGT technique.

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### Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- The potential basis enhancing advantages of the donor swapping his high basis assets for the income tax disregarded entity's low basis assets.
  - The low basis assets, if retained by the grantor, will receive a basis step-up on the grantor's death.
  - If the low basis assets are sold by the grantor before his or her death the cost of the capital gains taxes will be borne by the grantor (just as they would have been if the assets had been sold by the grantor trust or a disregarded single member FLLC).
  - The principal and interest of the donor's retained note may be paid with either cash or in kind. There will not be any income tax consequences with in kind payments, if the grantor trust or single member FLLC remains a disregarded entity.

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### Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Considerations of the swap technique.
  - The grantor may not have any high basis assets, or cash, to swap. If that is the case, consider a recourse third party loan of cash to the grantor from a third party lender. (While it may be tempting for the donor to simply purchase low basis assets from the disregarded entity, it is not clear what the disregarded entity's basis in the note is – the note's basis may be only equal to the basis of the purchased assets and capital gains consequences could accrue to the trust when the note is paid.)
  - The grantor could then use that cash to swap for the low basis asset. The grantor trust may then be converted to a complex non-grantor trust.
  - At a later time, in an independent transaction, the grantor could borrow the high basis cash from the trust with a long-term, recourse note that is unsecured, but pays a fair market value interest rate (which may be high), and use that cash to pay the principal of the third party loan.

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## Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- The retained note in the LAIDGT technique could be designed to (i) have a mandatory conversion of the amount of non-managing member interests that are equal in value to the principal balance of the note at the death of the holder of the note, and (ii) before death, at the election of the holder, the then outstanding principal of the note could be converted to that amount of non managing member interests that are equal in value to that outstanding principal or a private annuity.
  - There are several advantages in making the note convertible as described above.
    - When the note is converted, that act of conversion does not trigger sale treatment. See Revenue Ruling 72-265.
    - IRC Section 754 elective basis increase in underlying assets.
    - Supports the valuation of note.
      - The conversion feature will support the argument that the principal of the note is equal to its value.
    - Additional investment flexibility for holder.
      - The conversion feature will give the holder of the note additional flexibility to increase his or her future equity exposure.
    - Ability to turn disregarded entity status on and off.
      - The disregarded entity status of the FLLC, for income tax purposes, can be easily turned on or off by admitting or redeeming other owners who are not grantor trusts.

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## Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- There may need to be substantive equity in the trust from prior gifts (is 10% equity enough?) before the sale is made in the SIDGT technique in order for the note not to be treated as a retained interest in the trust under Equitable Tax Principles. That consideration may not exist with the LAIDGT technique.
  - The note needs to be treated as a note for tax purposes. Generally, estate and gift tax law follows state property law. Thus, there needs to be a strong likelihood that the note will be paid and the capitalization of the trust in the SIDGT technique should not be too “thin.” If the assets of the trust in the SIDGT technique are almost equal to the value of the note, the note may not be considered a note under equitable tax principles, but rather a disguised interest in the trust. If the note is considered a disguised interest in the trust, the provisions of the trust and the note may not satisfy the requirements of IRC Section 2702 and, thus, all of the assets of the trust could be considered as having been given to the donees without any offsetting consideration for the value of the note.
  - If the note is considered a disguised retained beneficial interest in the trust, instead of a note, the IRS may take the position that IRC Sections 2036 and/or 2038 apply on the death of the taxpayer.
  - Based on a private letter ruling in 1995 and the statutory make up of IRC Section 2701, many practitioners and commentators seem to be comfortable with leverage that does not exceed 90%.
  - In the LAIDGT, since the note is accruing from the FLLC, and not the trust, the “retaining a trust interest” consideration of the SIDGT technique may be avoided. If there is too much leverage with the LAIDGT technique part of the note will be reconstituted as equity in the FLLC and the disappointment will be that not as much equity will be transferred by gift to the recipient trust.
  - Secondly, because the note is convertible in the LAIDGT technique, there is a stronger argument that at all times the note will be repaid.

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Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- There may be capital gains considerations with respect to the note receivables and/or note payables that may exist with the grantor trust at the death of the donor under the SIDGT technique, but not with the LAIDGT technique with a convertible note that converts at the death of the holder.
- Transfer tax advantages of the LAIDGT.
  - The LAIDGT technique has all of the transfer tax advantages of the SIDGT technique.
  - The LAIDGT technique can be used to transfer assets from one grantor trust to another when there may be generation-skipping advantages or other advantages in making that transfer.

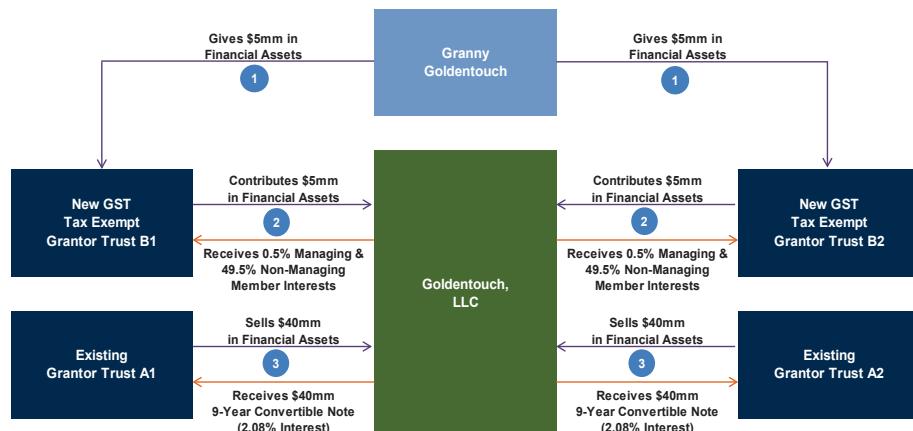
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Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Trust to trust transfer using the LAIDGT.
  - The technique is illustrated below:



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### Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Borrowing from a grantor trust.
  - Reasons to borrow from a grantor trust.
    - Source of liquidity.
    - Financing payment of income taxes.
    - Borrowing without income tax on interest.
    - Turning on grantor trust status.
      - Portion owned.
      - Using IRC Section 675(3) to acquire appreciated assets from a non-grantor trust to use to make charitable gifts.
    - “Reverse” installment sale to lock in estate tax exclusion before it expires.
    - Guarantee favorable, stable returns to grantor trust.

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### Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Gift tax risks of borrowing from a grantor trust.
  - Gift tax risks to borrower.
    - If the grantor borrows from an irrevocable trust, the borrowing will not be treated as a gift by the grantor for gift tax purposes, provided that the value of the grantor's obligation to repay is no greater than the borrowed cash. Normally, the grantor will not be treated as making a gift so long as the face amount of the obligation is equal to the borrowed cash. The value of a note, however, is determined in part by comparing the interest rate on the note to the prevailing interest rates on the market. In theory, therefore, an excessively generous interest rate payable to the grantor trust could cause the grantor to be treated as having made a taxable gift at the time of the borrowing.
  - Gift tax risks to beneficiary.
    - A trustee who makes a loan on favorable terms to the grantor – such as if the loan is unsecured or bears interest at low rate – may breach the trustee's duties to the beneficiaries, such as the duties of loyalty and prudence. Beneficiaries who fail to assert a claim for breach of fiduciary duty, and instead consent to or acquiesce in the loan, could conceivably be making an indirect gift to the grantor by permitting the value of their beneficial interests to be impaired by the loan.

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## Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Estate tax risks of borrowing from a grantor trust.
  - Gross estate inclusion risk.
    - In the context of a grantor borrowing from an irrevocable trust, the IRS could contend that, if the grantor-decedent borrowed on favorable terms, such as at a below-market interest rate, the borrowing is evidence of an implied understanding that the grantor would be given the enjoyment or right to income of the trust property.
    - IRC Section 7872 rate may not be an IRC Section 2036 safe harbor.
    - Additional IRC Section 2035(a) three-year tail risk.

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## Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Non-deductibility of estate tax risk.
  - General requirements of deduction under IRC Section 2053(a)(3).
    - In general, a claim is deductible under IRC Section 2053(a)(3) if it represents a personal obligation of the decedent, it existed at the time of the decedent's death, and it is enforceable against the decedent's estate and not unenforceable when paid. In addition, unless an exception applies, the claim must either be actually paid by the estate or must meet certain requirements to ensure that the amount of the debt is ascertainable.
  - Full and adequate consideration requirement.
    - If the grantor borrowed on terms excessively favorable to the grantor trust (such as if the interest rate is above-market), then the IRS could deny a IRC Section 2053(a)(3) deduction on the theory that the grantor's repayment obligation was not contracted for full and adequate consideration, but instead was a device for transferring wealth under cover of a deduction for claims against the estate.
  - General factors of bona fide loan.
    - In general, including for purposes of IRC Section 2053(a)(3), courts apply a number of factors in order to determine whether a purported debt is bona fide. These factors include: (1) The name given to an instrument underlying the transfer of funds; (2) the presence or absence of a fixed maturity date and a schedule of payments; (3) the presence or absence of a fixed interest rate and actual interest payments; (4) the source of repayment; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between creditors and equity holders; (7) the security for repayment; (8) the transferee's ability to obtain financing from outside lending institutions; (9) the extent to which repayment was subordinated to the claims of outside creditors; (10) the extent to which transferred funds were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayment. Any failure by the trust to deal with the grantor as a third-party lender creates a risk that the IRS would attempt to deny an estate tax deduction for the debt on the theory that the debt was not bona fide.

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### Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Using a form of a grantor trust known as a grantor retained annuity trust ("GRAT").

- What is a GRAT?

- One form of grantor trust is known as a GRAT. A GRAT is an irrevocable trust to which the grantor transfers an asset in exchange for the right to receive a guaranteed annuity for a fixed number of fiscal years (the "Annuity Period"). When the trust term expires, any GRAT balance remaining is transferred tax free to a designated remainder beneficiary (e.g., a "defective grantor trust" for the benefit of the grantor's spouse and issue).
    - A grantor's ability to determine the size of the guaranteed annuity and the annuity period at the outset allows the GRAT to be constructed so that the present value of the grantor's retained interest approximately equals the value of the property placed in the GRAT, resulting in a "zeroed out" GRAT. If the grantor survives the GRAT term and the GRAT earns a yield or otherwise appreciates at a rate that exceeds the Statutory Rate, the amount of such excess value should pass to the GRAT's designated beneficiaries free of transfer tax.

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### Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Considerations of using a traditional GRAT.

- Financial reasons why a GRAT may not succeed.

- Some assets are not volatile.
    - Some GRAT investments are only profitable if the investment is long.

- If a GRAT is not administered properly, the retained interest by the grantor may not be deemed to be a qualified interest.

- The *Atkinson* worry.
    - The annuity amount must be paid annually.
    - Paying the grantor in satisfaction of his retained annuity interest with hard to value assets may disqualify his retained interest from being a qualified interest, if the assets are valued improperly.
    - The contribution of assets to the traditional GRAT structure must be made at the exact point of the creation of the GRAT.

- The retained annuity interest is valued using the valuation principles under IRC Section 7520, which is typically higher than interest on an intra-family note.

- A successful GRAT could regress to the mean by the end of the term of the GRAT.

- The GST tax exemption may be difficult to leverage through the use of a traditional GRAT structure.

- A traditional GRAT structure will not be successful in transferring assets if the grantor does not survive until the end of the term of the GRAT.

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### Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Considerations of using a traditional GRAT.
  - Financial reasons why a GRAT may not succeed.
    - Some assets are not volatile.
    - Some GRAT investments are only profitable if the investment is long.
  - If a GRAT is not administered properly, the retained interest by the grantor may not be deemed to be a qualified interest.
    - The *Atkinson* worry.
    - The annuity amount must be paid annually.
    - Paying the grantor in satisfaction of his retained annuity interest with hard to value assets may disqualify his retained interest from being a qualified interest, if the assets are valued improperly.
    - The contribution of assets to the traditional GRAT structure must be made at the exact point of the creation of the GRAT.
  - The retained annuity interest is valued using the valuation principles under IRC Section 7520, which is typically higher than interest on an intra-family note.
  - A successful GRAT could regress to the mean by the end of the term of the GRAT.
  - The GST tax exemption may be difficult to leverage through the use of a traditional GRAT structure.
  - A traditional GRAT structure will not be successful in transferring assets if the grantor does not survive until the end of the term of the GRAT.

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### Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Possible structural solutions to address certain administrative and certain stewardship disadvantages of a traditional GRAT.
  - Structural solutions to prevent the inadvertent additional contribution of assets to a GRAT.
    - When creating the GRAT, the grantor may wish to consider a provision that prohibits any additional contributions to the GRAT and if any additional contribution is made, a new GRAT must be created specifically to hold that contribution.
    - The grantor of the GRAT may wish to consider initially making the trust revocable. Once all assignments to the trust have been completed, the grantor could amend the trust to make it an irrevocable GRAT.
  - Structural solutions to ensure that the annuity amount is always deemed to be paid on a timely basis.
    - The grantor of the GRAT may wish to consider a provision in the trust document that provides (pursuant to a formula) a portion of the trust that is equal to the Annuity Amount due to the grantor shall not be subject to the trust.
    - If that portion remains in the hands of the trustee after the annuity payment date, the trustee shall hold such property only as a nominee, or as an agent, for the grantor.
    - The grantor may also wish to consider a provision in the trust document that the portion of the trust estate that is being held in that agent capacity can be comingled with the trust assets and that the person also serving as trustee has full authority, as agent, to invest the property.
  - Structural solutions to limit the amount that is received by the remainderman of the GRAT.
    - The GRAT could be designed to provide that, on termination of the GRAT, the remainder value of the GRAT above a certain dollar value will revert back to the grantor.

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Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Solutions to reduce the mortality risk in GRATs.
  - The grantor could sell her retained annuity interest.
    - If the sale is made to a grantor trust or to a spouse, the sale will not have any income tax consequences. Although the transfer of a retained interest that would otherwise cause inclusion under IRC Section 2036 is presumptively subject to the three-year rule of IRC Section 2035(a), a sale for full and adequate consideration is exempt under IRC Section 2035(d). The IRS could characterize consideration equal to the remaining value of the annuity as not full and adequate for purposes of IRC Section 2035 under the doctrine of *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961). The viability of *Allen* may be questioned in light of the cases discussed in Section IV.C.5.e of the paper. Even if the sale is not for full and adequate consideration, if the grantor lives at least three years after the sale, IRC Section 2036 inclusion should be avoided.
  - The grantor could use a life insurance to hedge against an early grantor death.
  - The grantor could purchase the remainder interest in a profitable GRAT from the remainder beneficiaries.
  - The GRAT could be created by the grantor in consideration of full and adequate consideration.

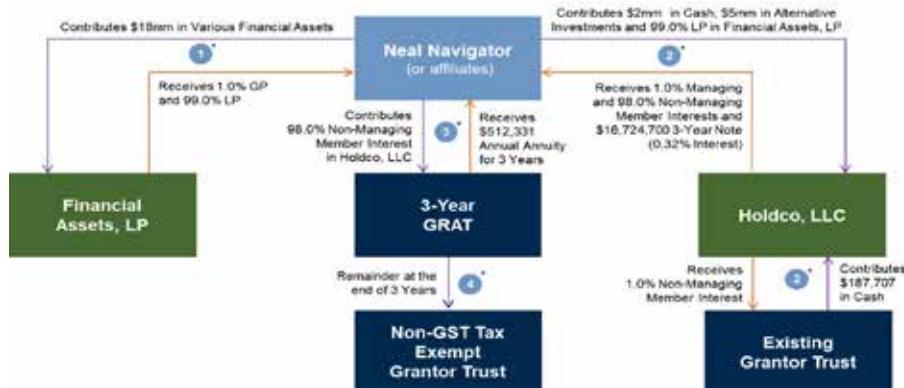
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Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Consider contributing an interest in a leveraged FLLC to a GRAT (the “LAGRAT” technique).
  - What is the LAGRAT technique?
    - The technique is illustrated below:



- The technique illustrated above is designed to join a discounted sale to a grantor trust to a near “zeroed out” GRAT so as to get the best of both worlds.

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Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private Wealth Management 

- Advantages of the LAGRAT technique.
  - If leverage is used in creating the FLLC that is contributed to the GRAT, much more wealth will be transferred to the remainderman of the GRAT than contributing assets that are not entities to a GRAT or a FLLC that is contributed to the GRAT without leverage.
  - See the tables below:

| Hypothetical Techniques<br>Scenario 1: Assets Earn 2.20% Annually,<br>IRS 7520 Rate of 2.20%         | Neal<br>Navigator | Navigator<br>Children | % Improvement<br>Over<br>Technique #1 | % Improvement<br>Over<br>Technique #2 |
|--|-------------------|-----------------------|---------------------------------------|---------------------------------------|
| No Further Planning  | \$26,553,039      | \$0                   | N/A                                   | N/A                                   |
| Technique A: Contributing Assets That Are Not in<br>Entities to a GRAT                               | \$26,552,894      | \$144                 | N/A                                   | N/A                                   |
| Technique B: Contribution of Non-Leveraged Entities<br>to a GRAT                                     | \$24,217,863      | \$2,335,176           | 1619182.15%                           | N/A                                   |
| Technique C: Leveraged FLLC Asset Contributed to a<br>GRAT   | \$18,781,789      | \$7,771,250           | 5388721.91%                           | 232.79%                               |
| Technique D: Two Leveraged FLLCs (Preferred and<br>Growth) Assets Contributed to Two Different GRATs | \$17,455,005      | \$9,098,034           | 6308754.37%                           | 289.61%                               |

Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private Wealth Management 

| Hypothetical Techniques<br>Scenario 2: Assets Earn 7.40% Annually,<br>IRS 7520 Rate of 2.20%         | Neal<br>Navigator | Navigator<br>Children | % Improvement<br>Over<br>Technique #1 | % Improvement<br>Over<br>Technique #2 |
|--|-------------------|-----------------------|---------------------------------------|---------------------------------------|
| No Further Planning  | \$30,292,932      | \$0                   | N/A                                   | N/A                                   |
| Technique A: Contributing Assets That Are Not in<br>Entities to a GRAT                               | \$27,409,575      | \$2,883,358           | N/A                                   | N/A                                   |
| Technique B: Contribution of Non-Leveraged Entities<br>to a GRAT                                     | \$24,501,033      | \$5,791,069           | 100.85%                               | N/A                                   |
| Technique C: Leveraged FLLC Asset Contributed to a<br>GRAT   | \$18,401,011      | \$11,691,122          | 312.41%                               | 105.33%                               |
| Technique D: Two Leveraged FLLCs (Preferred and<br>Growth) Assets Contributed to Two Different GRATs | \$17,080,468      | \$13,212,406          | 358.23%                               | 128.15%                               |

| Hypothetical Techniques<br>Scenario 3: Assets Earn 10.00% Annually,<br>IRS 7520 Rate of 2.20%        | Neal<br>Navigator | Navigator<br>Children | % Improvement<br>Over<br>Technique #1 | % Improvement<br>Over<br>Technique #2 |
|--|-------------------|-----------------------|---------------------------------------|---------------------------------------|
| No Further Planning  | \$32,295,905      | \$0                   | N/A                                   | N/A                                   |
| Technique A: Contributing Assets That Are Not in<br>Entities to a GRAT                               | \$27,826,552      | \$4,469,353           | N/A                                   | N/A                                   |
| Technique B: Contribution of Non-Leveraged Entities<br>to a GRAT                                     | \$24,569,260      | \$7,726,645           | 72.00%                                | N/A                                   |
| Technique C: Leveraged FLLC Asset Contributed to a<br>GRAT   | \$18,186,732      | \$14,109,173          | 215.09%                               | 82.00%                                |
| Technique D: Two Leveraged FLLCs (Preferred and<br>Growth) Assets Contributed to Two Different GRATs | \$16,784,233      | \$15,511,672          | 247.07%                               | 100.76%                               |

## Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Under all rates of return, the LAGRAT substantially outperforms the other GRAT techniques. The reason for the improved performance with the contribution of member interests in a leveraged FLLC is (i) the average hurdle rate is lower with leverage and (ii) the GRAT annuity amount is paid with the normal distributable cash flow of the FLLC instead of discounted FLLC member interests. The chief reason for the outperformance is the second reason. A significant arbitrage is created when a heavily discounted asset is contributed to a GRAT and undiscounted cash is used to pay the annuity.
- Other advantages of the LAGRAT in comparison to a GRAT.
  - As noted, not only does paying the GRAT annuity with cash, instead of discounted entity interests, produce a much better transfer tax result, it does not present “deemed contribution” or “deemed commutation” concerns that could accrue if hard to value assets are used to pay the GRAT annuity.
  - The LAGRAT technique has many of the same advantages as the sale to the grantor trust.
  - There is inherent flexibility to meet changing consumption needs with the grantor retaining a note from the FLLC that could be converted to a note with a different interest rate or a private annuity.
  - There is an inherent flexibility to enter into basis enhancing strategies with the LAGRAT.
  - The “Atkinson” worry about paying a GRAT annuity with a hard-to-value asset may be eliminated.
  - There may be less danger that the retained note will be recharacterized as a deemed retained interest in a trust under equitable tax principles with this technique than with a sale to a grantor trust.
  - There is greater authority that a sale to a single member FLLC will be treated as a non taxable sale to a disregarded entity for income tax purposes than there is for a sale to a grantor trust.
  - The LAGRAT avoids the necessity of continually creating GRATs using the so-called “cascading GRATs” technique.

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## Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Considerations of the LAGRAT technique.
  - If the grantor does not survive the term of the GRAT, part or all of the net value of the leveraged FLLC interests owned by the GRAT and the then value of the outstanding note receivable from the FLLC could be taxable in the grantor’s estate.
  - The LAGRAT is more complex to initially create than the traditional GRAT (but it is less complicated than using the alternative “freeze” technique of cascading GRATs that would be created each year).
  - Care must be taken to make sure that there is not a violation of the treasury regulation that prohibits “issuance of a note, or other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount.”
  - Care must be taken to make sure that the IRS cannot successfully take the position that the creation of Holdco, FLLC should be ignored for gift tax purposes and that the retained notes are in reality retained trust interests in the GRAT that do not constitute a qualified annuity interest under IRC Section 2702.
  - Care must be taken if the underlying asset that is sold or contributed to the single member FLLC is stock in a subchapter S corporation.

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Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Possible structural solutions to allow the allocation of the GST exemption upon the creation of a GRAT.
  - If there is a 5% or less probability that estate tax inclusion will occur because of the death of the grantor (e.g. a two year GRAT in which the grantor is under age 70), is there an exception to the ETIP rules applying, which allows an upfront allocation of a GST exemption?
    - While the GST exemption could be allocated to the GRAT, the GRAT annuity probably cannot be subtracted in determining the allocation GST exemption. This is generally a small consideration with the LAGRAT technique because the annuity is small.
  - Is there a technique that uses the leverage of the GRAT to indirectly profit a GST trust in which a skip person is not the remainderman of the GRAT at the beginning or end of the ETIP (and does the technique work)?

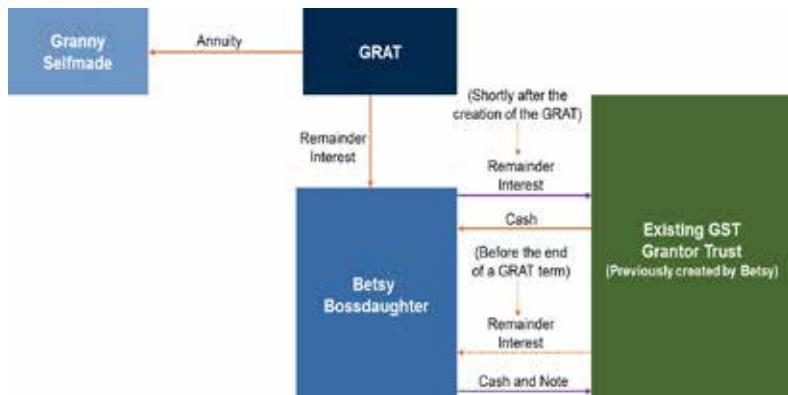
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Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- The technique is illustrated below:



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**Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)**

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- The remainder interest in a GRAT that is indirectly held by the grantor of the GRAT is sold for full and adequate consideration to an existing GST grantor trust.
- The technique is illustrated below:

The diagram illustrates the flow of assets and ownership between four entities:

- Granny Selfmade** (blue box) is the grantor of the GRAT.
- GRAT** (dark blue box) is a Grantor Retained Annuity Trust.
- Granny Selfmade LLC** (blue box) is a limited liability company owned by Granny Selfmade.
- Existing GST Grantor Trust** (green box) is an Existing Grantor Trust.

The flow of assets is as follows:

- Step 1:** **Granny Selfmade** contributes **\$5,000,000 in Financial Assets** to the **GRAT**.
- Step 2:** **Granny Selfmade** contributes **\$4,649,000 in Annuity Payments** to the **GRAT**.
- GRAT** makes **Remainder Beneficiary** payments to the **Remainder Beneficiary**.
- Granny Selfmade** sells **100% Member Interest in Granny Selfmade LLC** to the **Existing GST Grantor Trust**.
- Granny Selfmade** receives **\$500,000 in Financial Assets** from the **Existing GST Grantor Trust**.

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**Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)**

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- Advantages of the technique.
  - The technique should avoid gift taxes.
  - Assuming the grantor of the GRAT receives full consideration, the technique should avoid all estate taxes and generation-skipping transfer taxes, even if the grantor dies during the term of the GRAT annuity.
    - IRC Section 2036(a) does not apply if Granny receives full consideration. However, if there is even a \$1.00 gift, and if Granny dies during the term of the GRAT, all of the value of the GRAT at the time of Granny's death, will probably be brought back into her estate minus the value Granny received in transaction 2 (see IRC Section 2043).
  - When the GRAT terminates and the existing GST grantor trust receives Granny's FLLC interest, that should not be treated as an addition for purposes of requiring an adjustment to the existing GST grantor trusts inclusion ratio, assuming the existing GST grantor trust pays full consideration for Granny's interest.

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Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Considerations of the technique.
  - There is no authority that explicitly supports the advantages outlined above, other than the analysis offered in this paper.
  - It is crucial for the grantor to have received full consideration in above transaction 2.
  - It may be crucial that the remainder interest of the GRAT that is sold has substance and is not a de minimis amount.

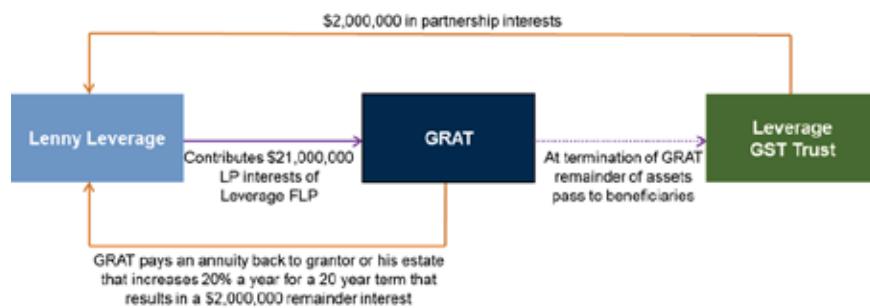
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Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- The creation of a GRAT for full and adequate consideration.
  - The technique is illustrated below:



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**Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)**

Private  
Wealth  
Management



- Advantages of the technique.
  - Significant value can be transferred because of the leverage of a GRAT.
  - The creation of the joint purchase GRAT is not subject to the ETIP rules and the creation of the GRAT does not constitute a transfer to the GST trust.

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**Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)**

Private  
Wealth  
Management



- Considerations of the technique.
  - It is crucial to avoid valuation issues with this technique.
  - There could be abusive situations where the remainder interest is very small and the logic of the *Wheeler*, *D'Ambrosio* and *Magnin* cases would not be applied.
  - If the GRAT is for a term of years with the GRAT annuity payable to the grantor or his estate and the grantor dies before the end of the term, there could be unfavorable estate tax and income tax consequences.

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**Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)**

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- A gift tax free transfer to a grantor trust: the remainder purchase marital trust technique.
  - The technique is illustrated below:

The diagram illustrates the RPM technique. It starts with a large green box labeled "Financial Assets FLP". An arrow labeled "1" points from the FLP to the "Existing GST Tax Exempt Grantor Trust (for the benefit of Remainder Family)". From the trust, an arrow labeled "1" points to the "Robby Remainder". Another arrow labeled "1" points from the FLP to the "RPM Trust (for the Lifetime Benefit of Reba Remainder)". An arrow labeled "2" points from the Robby Remainder to the RPM Trust. The RPM Trust then points to the "Reba Remainder". The diagram is annotated with the following text:

- Contributes \$60mm Financial Assets & \$20mm in Alternative Investments
- Receives 1.8% GP & 78.0% LP Interests
- Purchases Remainder Interest with 15.0% LP Interest (assumed discounted value of \$10.5mm)
- Contributes 60.0% LP Interest (assumed discounted value of \$42mm)
- Annual Annuity of \$2.0mm for Reba's Lifetime

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**Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)**

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- Advantages of the technique.
  - Tax advantages of creating a grantor trust and transferring assets to the grantor trust with significant lifetime leverage, which could result in a significant amount being transferred to the remainder trust.
  - The near term death of the grantor, or the grantor's spouse, generally does not affect the technique like the death of a grantor of a GRAT.
  - The appreciation of the assets will be out of the grantor's estate and the spouse of the grantor's estate.
  - The grantor and the grantor's spouse will have available for their consumption needs the consideration paid by the Remainderman Trust and the distributions paid pursuant to the beneficial provisions of the RPM Trust (and perhaps the Remainderman Trust).
  - There is more flexibility in the design of the structure in comparison to a GRAT because IRC Section 2702 does not apply to the technique and it is easier to do leveraged GST planning in comparison to a GRAT.
  - The technique could also serve as a qualified personal residence trust (QPRT) substitute and could be a very good vehicle for planning for art.

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Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Considerations of the technique.
  - It requires a spouse beneficiary.
  - The RPM Trust cannot have a divorce clause, but it could be an advantageous technique to use in pre-divorce planning.
  - It is crucial that the Remainderman Trust pay full consideration.
  - The step transaction doctrine could apply.
  - The need for “substance” with respect to the purchase by the Remainderman Trust.
  - It is crucial that the remainder and term interests in the RPM Trust be transferred simultaneously.
  - The interest on the note received by the selling spouse will be taxable income to that selling spouse and there will be a corresponding deduction to the spouse who created the grantor trust.
  - The RPM transaction will only be a profitable transaction to the Remainderman Trust if the assets subject to the remainder purchase grow faster than what the consideration utilized by the Remainderman Trust would have otherwise increased.

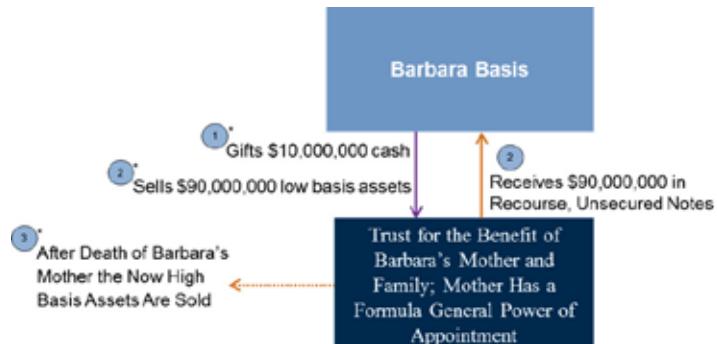
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Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- The gifting and selling low basis assets to a grantor trust where an older generation is a beneficiary and is subject to an older generation’s formula general power of appointment and estate taxes (“UPIDGT”) technique.
  - The technique is illustrated below:



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

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### Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Income tax and basis enhancing advantages of the UPIDGT technique.
  - This technique has the same advantages as a SIDGT.
  - The assets of the trust will receive a step-up in basis on the older generation beneficiary's death equal to the fair market value of the assets, if the net value rule of IRC Section 1014(b)(9) does not apply.

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### Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Transfer tax advantages of the UPIDGT technique.
  - The non-depreciable assets of the trust may be generation-skipping tax protected.
  - The older generation beneficiary may not have to pay estate taxes because of her formula general power of appointment, if her then available unified credit exceeds the net value of the trust.
  - Also consider the income and transfer tax advantages that could accrue if the older generation exercises her testamentary formula general power of appointment in favor of a BDOT, in an independent transaction, in which the younger generation creator of the UPIDGT is the initial beneficiary.
  - A BDOT could become, under those circumstances, an ideal trust for the younger generation (Barbara) to sell her individual assets to the BDOT, or the younger generation could use the LAIDGT technique with that BDOT.

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### Some of the Best Creative Tax Planning Techniques for Grantor Trusts (Continued)

Private  
Wealth  
Management



- Considerations of the UPIDGT technique.
  - The grantor of the trust will still have a low basis in his or her note upon the death of the older generation beneficiary.
  - The older generation beneficiary could exercise his or her general power of appointment in an unanticipated way.
  - Many of the same considerations for the use of a grantor trust and a sale to a grantor trust would also be present for this technique.
  - The effect of IRC Section 1014(e) must be considered, if cash is not given and low basis assets are used to capitalize the trust.
  - Is grantor trust status lost for the original grantor when the older generation beneficiary dies and the trust assets are included in the beneficiary's estate?
    - Treas. Reg. § 1.671-2(e)(6) contains an example that would seem to indicate that the grantor trust status would not change, if the older generation does not exercise his or her general power of appointment.
  - IRC Section 1014(b)(9) needs to be considered for property that has depreciated.

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### Some of the Best Creative Tax Planning Techniques for Spousal Grantor Trusts (Pages 133-144 of the Paper)

Private  
Wealth  
Management



- The advantages of a transferor selling assets to a trust that names the transferor as a beneficiary, gives the transferor a testamentary special power of appointment and under which the transferor's spouse is considered the income tax owner ("Spousal Grantor Trust").
  - What is the technique?
    - If the taxpayer is a beneficiary of a spousal grantor trust and holds a power of appointment over its assets, the taxpayer's sale of property to the trust will permit the taxpayer to benefit from the property's future income and appreciation and to direct how others will enjoy it without exposing the property's income or appreciation to estate tax in the estate of either spouse.

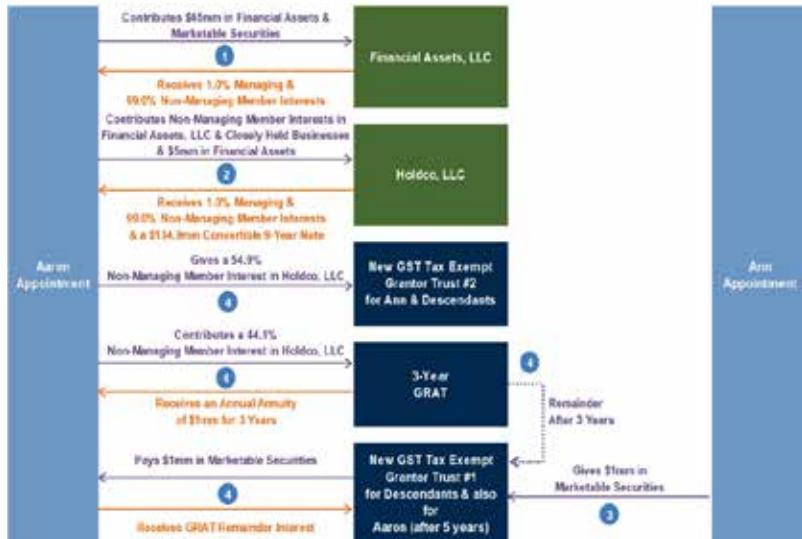
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Some of the Best Creative Tax Planning Techniques for Spousal Grantor Trusts  
(Continued)

Private  
Wealth  
Management



- The technique is illustrated below:



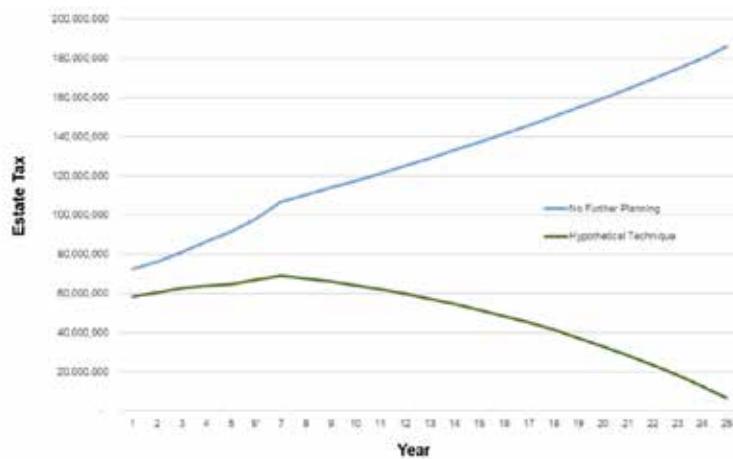
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Some of the Best Creative Tax Planning Techniques for Spousal Grantor Trusts  
(Continued)

Private  
Wealth  
Management



- Line graph showing the advantage of the technique, under the facts of the above example, over 25 years.



\*It is assumed that the increased estate tax exemption sunsets in 2025 (year 8).

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### Some of the Best Creative Tax Planning Techniques for Spousal Grantor Trusts (Continued)

Private  
Wealth  
Management



- Advantages of the sale to a Spousal Grantor Trust.
  - Transfer tax advantage of the technique.
  - Income tax advantages of the technique.
    - There will be no capital gains consequence on the original sale of the assets to the trust.
    - By using basis enhancing techniques the basis of the taxpayer's assets may be increased.
    - The technique has the asset class location advantage of the SIDGT technique.

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### Some of the Best Creative Tax Planning Techniques for Spousal Grantor Trusts (Continued)

Private  
Wealth  
Management



- Considerations of the Technique.
  - Federal income tax considerations.
  - State income tax considerations.
  - It is prudent to file gift tax returns.
  - Reciprocal trust doctrine considerations.
  - Some commentators have expressed the consideration that if it is possible for a current creditor, or any future creditor, of the assigning beneficiary to reach part of the assets of the spousal grantor trust for a period of time that does not end before the assigning spouse/beneficiary's death, by either voluntary or involuntary assignment by the assigning spouse/beneficiary, then that part of the trust may be included in the assigning spouse/beneficiary's estate under IRC Sections 2036 or 2038.
  - If a current or future creditor of an assigning beneficiary does reach part of the assets of a self-settled trust, then that part of the trust may not constitute a completed gift for gift tax purposes.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Pages 144-199 of the Paper)

Private  
Wealth  
Management



- IRC Section 678 Overview: Three paths to beneficiary ownership.
  - IRC Section 678(a)(1) ownership because of power to vest corpus or income of the subject trust.
    - First, under IRC Section 678(a)(1), a person other than the grantor is treated as the owner of any portion of a trust with respect to which that person has a power, "exercisable solely by himself," to vest the corpus or the income of such portion in himself, herself, or itself. Although the IRS does not appear to have embraced the term, in recent years, trusts treated as owned by a person other than the grantor under IRC Section 678(a)(1) have been referred to as "beneficiary defective owned trusts" or "BDOTs."
  - IRC Section 678(a)(2) ownership because of partial release or other modification of vesting power, plus other grantor trust strings.
    - Second, under IRC Section 678(a)(2), a person other than the grantor is treated as the owner of any portion of a trust with respect to which that person has "previously partially released or otherwise modified" an IRC Section 678(a)(1) vesting power and retains an interest in or control over the trust that would cause the grantor to be treated as the trust owner under IRC Sections 671 through 677. IRC Section 678(a)(2) trusts are frequently referred to as "beneficiary defective inheritor's trusts" or "BDITs," in contrast to their BDOT cousins.
    - Deemed IRC Section 678(a) ownership via a QSST.
    - The beneficiary of a qualified subchapter S trust, as defined in IRC Section 1361(d)(3), may make an election to be treated as the owner under IRC Section 678(a) of the portion of the trust which consists of stock in an S corporation.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- Grantor's ownership trumps beneficiary ownership.
  - IRC Section 678(b) provides that IRC Section 678(a) does not apply "with respect to a power over income" if the grantor is otherwise treated as the owner of under IRC Sections 671-677 and IRC Section 679.
  - Although IRC Section 678(b) refers to a power over "income," the IRS has consistently viewed a grantor trust string with respect to corpus as overriding beneficiary ownership under IRC Section 678(a).
  - To achieve IRC Section 678(a) beneficiary ownership, therefore, it is essential, if the grantor is still living, to negate all possible grantor trust strings with respect to the grantor.
  - Sales to BDITs and BDOTs a no rule area.
    - Perhaps reflecting IRS concerns with aggressive IRC Section 678(a) extremely leveraged sale planning, the IRS will not ordinarily rule on IRC Section 678 status "if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased."

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**Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)**

Private Wealth Management | 

▪ Sales to LLCs Owned by BDOTs.

- This section analyzes the technique of a transferor selling assets for a note to a limited liability company that is owned by a third party created trust that is a BDOT in which the selling transferor, as the beneficiary of the BDOT, has the power to withdraw in any calendar year of the trust, all of the net taxable income (accounting income and capital gains income) of the trust earned by all of the trust assets, and that withdrawal power can be satisfied out of the entire accounting income and/or corpus and/or proceeds of the corpus of the trust (sometimes referred to below as the "Income Withdrawal Right Beneficiary").
- Application of IRC Section 678(a)(1).
  - IRC Section 678(a)(1) provides as follows:
 

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

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

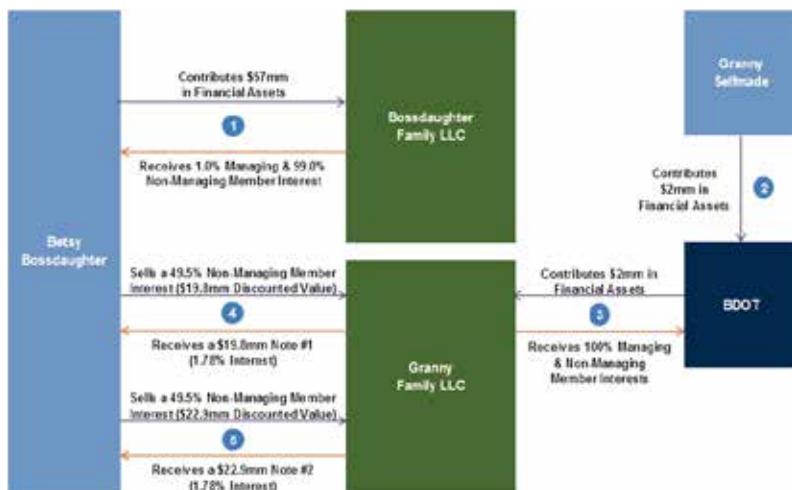
The reference to "income" in Section 678(a)(1) is taxable income and not accounting income. If a beneficiary of a BDOT has the right to withdraw net taxable income, the beneficiary has the right to withdraw not only dividends and interest, but income normally allocated to principal such as capital gains income.

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**Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)**

Private Wealth Management | 

- The technique is illustrated below:



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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- Income tax advantages of the technique.
  - The technique has all of the income tax advantages of the SIDGT technique or the LAIDGT technique.
    - A sale by the beneficiary of the BDOT to the BDOT, under the regulations under IRC Sections 671-677, 678 and 1001 would appear to have the same advantages as the SIDGT technique or the LAIDGT technique.
  - Revenue Ruling 85-13, 1985-1 C.B. 184, citing the authority of *Dobson v. Commissioner*, 1 B.T.A. 1082 (1925) and other authorities concluded that "a transaction cannot be recognized as a sale for income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction." (Emphasis added.)
  - The ruling also cited several authorities, which hold that when the grantor of a grantor trust is treated as the income tax owner of the trust for income tax purposes, the grantor is also considered the owner of the trust assets for income tax purposes.
  - Assume a grantor sells assets to a trust which gives the grantor the right to withdraw all realized income of the trust from whatever the source of that realized income, including all accounting income and realized capital gains income and that withdrawal right could be satisfied from any asset or cash source of the trust, including accounting income, sale proceeds of corpus assets or corpus. Under the authority of IRC Section 671 and 677, Treas. Reg. §§1.671-2, 1.671-3, 1.677(b)(2), 1.677(c) and 1.677(g) example 2 and Rev. Rul. 85-13 the sale is ignored for income tax purposes. Likewise, a sale by a beneficiary of a trust who has the right to withdraw in any calendar year, as the beneficiary of the trust, all of the realized income from the trust, from whatever the source of that realized income, including all accounting income and realized capital gain and that withdrawal right could be satisfied from any asset or cash source of the trust, including accounting income, sale proceeds of corpus assets or corpus.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- What does it mean for a "portion" to be treated as owned under IRC Section 678?
  - Perhaps the beginning point of the analysis of what is the meaning of the term "portion" under IRC Section 678(a)(1), is Treas. Reg. § 1.678(a)-1(a). The key part of the first sentence of that regulation provides "where a person other than the grantor of a trust has a power exercisable solely by himself to vest ... the income of any portion of a ... trust in himself, he is treated under section 678(a) as the owner of that portion ...." (Emphasis added.)
  - The last sentence of Treas. Reg. § 1.678(a)-1(a) incorporates, for purposes of IRC Section 678(a)(1), the grantor trust rules, which describe generally how the income tax rules work under IRC Section 671(a)(1) for any deemed income tax owner of any portion of a trust under IRC Section 671, Treas. Reg. §§ 1.671-2 and 1.671-3. These rules apply also in determining the treatment for any deemed income tax owner of any portion of an IRC Section 678(a)(1) trust: "See [IRC] 671 and [Treas. Reg.] §§ 1.671-2 and 1.671-3 for rules for treatment of items of income, deductions and credit where a person is treated as the owner of all or only a portion of a trust."
  - Similar to IRC Sections 677(a)(1) and 677(a)(2), under IRC Section 678(a)(1), an Income Withdrawal Right Beneficiary may only have the right to vest taxable income in himself, but that is enough for the Income Withdrawal Right Beneficiary to be the deemed owner for income tax purposes of all of the trust property. While there may be transfer tax differences between a corpus withdrawal beneficiary and an Income Withdrawal Right Beneficiary of a BDOT, there do not appear to be any income tax differences.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- If IRC Section 671, Treas. Reg. §§ 1.671-2 and 1.671-3 are incorporated in analyzing the operation of IRC Section 678, then the rationale of Rev. Rul. 85-13 for not recognizing a taxable sale by the deemed owner would also seem to apply. Since an Income Withdrawal Right Beneficiary has the power to withdraw the taxable income from all trust assets and the power to satisfy that withdrawal right from either the accounting income, sale proceeds of the corpus, or the corpus of all portions of the trust, that Income Withdrawal Right Beneficiary should be the deemed income tax owner of all of the assets of the subject trust, including any consideration that is sold to the trust. It does not matter under Rev. Rul. 85-13 whether IRC Section 671 applies because of a grantor's retains rights and powers over corpus, corpus and income, or income only (see IRC Section 677). Similar to the application of IRC Section 677 under Rev. Rul. 85-13, IRC Section 678(a)(1) would appear to apply to an Income Withdrawal Right Beneficiary who only has powers and rights over income.
- Indirect support for this conclusion can also be found in *Bennett v. Comm'r*, 79 TC 470 (1982), which held that a grantor was treated as the owner of a larger portion of the trust than the portion that the grantor had actually borrowed. By the same reasoning, the deemed ownership of an Income Withdrawal Right Beneficiary should be greater than the amounts that he or she may actually withdraw. Further support can be drawn from PLR 201633021, in which a power to withdraw "any dividends, interest, fees" and other amounts of fiduciary accounting income created deemed ownership over all income of a trust, including capital gains income.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- Sales to a Single-Member LLC owned by grantor trusts or BDOTs as alternative technique if Rev. Rul. 85-13 is revoked by the IRS or deemed not to apply to BDOTs.
  - Rev. Rul. 85-13 is an IRS analysis of a grantor deemed owner trust and whether activities and transactions by a grantor are disregarded. What if the IRS argued that it is not bound by Rev. Rul. 85-13 with respect to an Income Withdrawal Right Beneficiary of a BDOT and it will follow the analysis in *Rothstein*?
  - If the taxpayer is worried about that potential IRS argument, the taxpayer should consider selling to a single member LLC that is created by a BDOT in which the taxpayer is considered the deemed income tax owner. See Treas. Reg. § 301.7701-3(a); Treas. Reg. § 301.7701-3(b)(1)(ii) and Treas. Reg. § 301.7701-2(a).
  - The "disregarded" income tax protection of a single member LLC is broader than the grantor trust income tax protection.
  - The single member LLC regulations make clear not only that the income, deductions and credits of the single member LLC are treated as if the income tax owner of the LLC owns the assets of the LLC, but in addition that all activities and transactions that the LLC has with the LLC owner are treated for income tax purposes as if those transactions were transactions a sole proprietor would have with himself. In particular, Treas. Reg. § 301.7701-2 provides:

"Its activities are treated in the same manner a sole proprietorship . . . of the owner. (Emphasis added.)

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

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Management



- Assuming the Income Withdrawal Right Beneficiary of a BDOT is considered the income tax owner of any single member LLC formed by the BDOT (see the above analysis), then the above single member LLC income tax regulations would appear to be authority for the proposition that any sale or similar activity by the Income Withdrawal Right Beneficiary of a low basis asset to a single member LLC owned by a BDOT should also be disregarded.
- This analysis seems compelling at a technical level, but it has yet to be approved by the IRS or a court. It remains possible that the IRS or a court would take a policy-oriented "big picture" approach and ask why, if a sale by the Income Withdrawal Right Beneficiary to the BDOT would not be disregarded, putting a disregarded entity between the Beneficiary and the BDOT should alter the result.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- Summary of conclusions.
  - Case law, regulatory and revenue ruling authorities provide that if a taxpayer sells an asset, and if that taxpayer is deemed to be the income tax owner of that asset both before and after the sale, that sale is disregarded for income tax purposes.
  - Since IRC Section 671, Treas. Reg. §§ 1.671-2 and 1.671-3 apply to an IRC Section 678(a)(1) trust, the Income Withdrawal Right Beneficiary of the IRC Section 678(a)(1) trust should be treated the same as a grantor of a grantor trust.
  - There is no specific regulatory authority under either IRC Section 671, Treas. Reg. §§ 1.671-2 or 1.671-3 that activities and transactions that either a grantor of a grantor trust has with that grantor trust, or an Income Withdrawal Right Beneficiary has with an IRC Section 678(a)(1) trust, are to be disregarded for income tax purposes. There is case law authority that those activities should not be disregarded. See *Rothstein v. United States*, 735 F.2d 704 (2nd Cir 1984).
  - There is authority under Rev. Rul. 85-13, 1985-1 CB 184 that activities and transactions that a grantor has with a grantor trust are disregarded because the taxpayer owns the asset before and after the transaction. The analysis inherent in that revenue ruling should indicate that activities and transactions that an Income Withdrawal Right Beneficiary has with an IRC Section 678(a)(1) trust should also be disregarded. PLR 202022002 (May 29, 2020) arguably supports that analysis.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- There is specific regulatory authority that activities and transactions that a deemed income tax owner of a single member LLC has with that LLC are disregarded for income tax purposes.
- Failing to take the withdrawing income is not relevant to the IRC Section 678 analysis.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- Other income tax advantages.
  - The BDOT can be designed to be very flexible for any calendar year by giving an independent trustee, or a protector, the power to change the withdrawal power for a future year or years.
  - The BDOT has many income tax advantages that a complex trust does not have.
    - The taxable income is taxed at the beneficiary's marginal income tax rate, which is frequently lower than the trust's marginal federal income tax rate.
    - The taxable income is taxed at the beneficiary's marginal state income tax rate, which is frequently lower than the trust's marginal state income tax rate.
      - The beneficiary may move to a state with low or no state income taxes and the concerns with a high-income tax state's "resident trust" requirement would be eliminated.
  - The beneficiary of a BDOT can take an IRC Section 179 expense deduction while a complex trust's ability to take that deduction is limited.
  - Depending upon the BDOT beneficiary's tax bracket, and/or how active the beneficiary is in a closely held business, the 3.8% net investment income tax may not apply while under the same circumstances it may apply to a complex trust.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- The BDOT can be a shareholder of an S corporation without some of the considerations of an ESBT or a QSST.
  - The beneficiary of a BDOT may be entitled to certain deductions that are eliminated by ESBTs. A QSST has to pay the trust accounting income of the QSST to the beneficiary, while a BDOT does not pay any income to the beneficiary unless the withdrawal right is exercised.
- Capital losses can be passed through to the beneficiary of the BDOT.
  - Assets that have a capital loss could be distributed in kind.
- The capital gains benefit of a residence that is inherent under IRC Section 121 will be available to sales of residences owned by a BDOT.
- There are increased opportunities for charitable planning because the inherent limitations under IRC Section 642(c) will be eliminated.
  - The beneficiary can withdraw assets that accrued from sources other than gross income in satisfaction of its withdrawal rights, and those assets can then be contributed by the beneficiary to charities.
- A BDOT should avoid overlapping state fiduciary income taxation.
  - The beneficiary-owner, however, could be subject to overlapping state individual income taxation.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- Transfer tax advantage of the technique.
  - The beneficiary has the opportunity by her actions to increase the value of the BDOT and, thus, the amount that is not subject to estate taxes.
    - To the extent the beneficiary of a BDOT does not withdraw net taxable income of the BDOT up to the lapse protection (the so-called "5 and 5" protection of IRC Section 2514(e)(2) and IRC Section 2041(b)(2)), that amount remains in the trust in a manner that will not be subject to gift taxes and estate taxes. Almost all states have legislation that protects the protected lapse portion described in IRC Sections 2514(e)(2) and 2041(b)(2) from creditors.
  - Because the beneficiary is the deemed income tax owner of the BDOT, there is flexibility to allow the beneficiary to sell life insurance policies to the BDOT.
  - A sale by an income right withdrawal beneficiary to a BDOT Has all of the transfer tax advantages of a LAIDGT.
  - The BDOT technique has a greater safety valve than the SIDGT or a LAIDGT for protecting the seller, since the seller both has withdrawal rights in and is a beneficiary of the BDOT.

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**Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)**

Private  
Wealth  
Management



- The BDOT technique can be used to transfer assets from a trust that is a non-grantor trust to a newly created non-grantor trust.
  - Can a trust be a deemed owner of another trust under IRC Section 678 under the treasury regulations? Yes.
  - Treas. Reg. § 1.671-2(a)(6), Example 8 confirms that under IRC Section 678(a)(1) a trust can be the deemed income tax owner of another trust.
  - PLR 201633021 (8/12/2016) also held that a trust can be a withdrawing income beneficiary of another trust that is designed to be a BDOT.

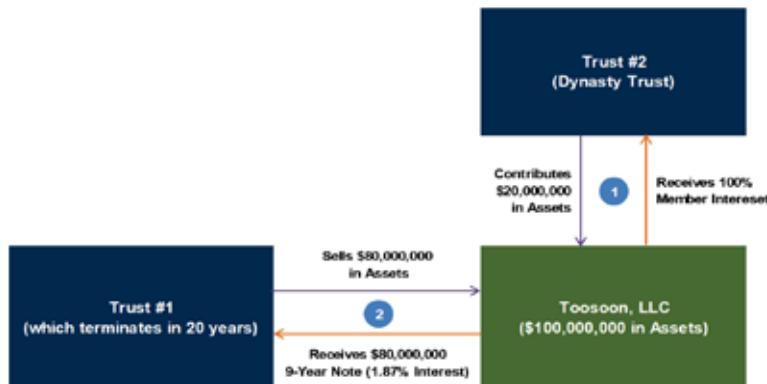
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**Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)**

Private  
Wealth  
Management



- The technique is illustrated below:



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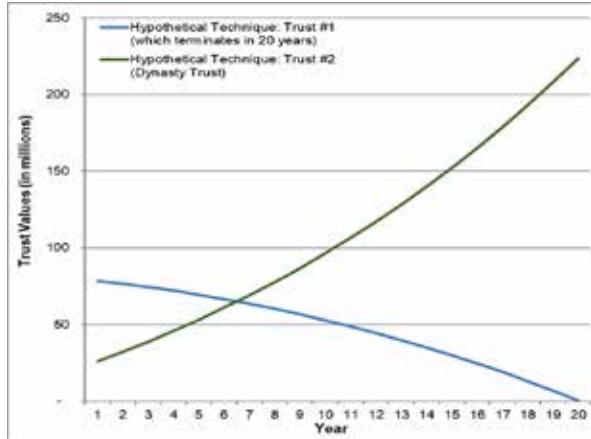
**Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor  
Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse  
(Continued)**

Private  
Wealth  
Management



▪ Advantages of the technique

- Wealth will be indirectly transferred from Trust 1 to Trust 2 because Trust 1 is paying all of the income taxes generated by the trust assets by both Trust 1 and Trust 2 and because the earnings and growth of the combined trusts is projected to be much higher than the projected 1.87% interest carry.



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**Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor  
Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse  
(Continued)**

Private  
Wealth  
Management



- The BDOT combined with a sale from one trust to another may be superior to the technique of decanting from one trust to another trust. In some states the option of a successful decanting of a particular trust may not exist.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- Consideration of the technique.
  - The technique has the considerations of using the BDOT technique.
  - The technique could be disadvantageous to the beneficiaries of the withdrawing power selling trust unless they are also beneficiaries and/or the objects of their bounty are beneficiaries of the trust.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- Other Uses of Beneficiary-Owned Trusts.
  - Interest-free loans to beneficiary.
    - The potential problem.
      - The treatment of a below-market loan from a trust to a beneficiary of the trust to whom distributions of income may or are required to be made is not clear. Although beneficiary loans are not specifically listed in the portion of IRC Section 7872 that lists the below-market loans to which IRC Section 7872 applies, there is some concern that the IRS could take the position that they are "tax avoidance loans."
    - The beneficiary-owned trust solution.
      - If the beneficiary is treated as the owner of a trust, loans from the trust to the beneficiary should be ignored for income tax purposes. If it is undesirable to give the beneficiary complete income tax ownership of the trust, ownership could be limited to the income from that portion of the trust that the trustee intends to lend to the beneficiary.
    - Beneficiary ownership of state source income.
      - The Potential problem.
        - At least two states, New Jersey and New York, impose state income tax on trusts that were funded by state domiciliaries if the trusts earn income that is sourced within the state. When trusts invest in pass-through entities, it is difficult to ensure that at least some small portion of the trust's share of the pass-through entities' income will not consist of income sourced in one of these states.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- The beneficiary-owned trust solution.
  - Give one of the beneficiaries of the trust a withdrawal power over all income sourced in New York, in the case of a trust funded by a New York domiciliary, or sourced in New Jersey in the case of a trust funded by a New Jersey domiciliary. If this is done, IRC Section 678 should cause the trust income sourced in the applicable state to be treated as owned for income tax purposes by the beneficiary, not the trust.
- Consider using the BDOT technique, in combination with an accumulation trust, to facilitate IRA planning for descendants.
  - After passage of the Secure Act, IRAs must terminate in 10 years for descendants who are older than the age of majority.
  - A conduit trust for a descendant who is older than the age of majority will terminate in 10 years.
  - An accumulation trust for a descendant will not have to terminate in 10 years. However, the balance in the subject IRA will all be paid to the accumulation trust after 10 years which will be taxed at the trust's high tax rate.
  - If the accumulation trust for the descendant is designed to be a BDOT, the IRA proceeds will be taxed at the descendant's income tax rates, which may be much lower than the trust's income tax rates.
  - In future years the taxable income of the trust will also be taxable at the descendant's income tax rates, which may be much lower than the trust's income tax rates.
  - If the beneficiary withdraws from the trust only that amount necessary to pay income taxes associated with the trust, the beneficiary will maximize the creditor protection and other benefits of the trust.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- Using the springing BDOT technique to lengthen the benefit of a grantor trust.
  - A grantor trust could be drafted to provide that the trust's beneficiary (which could be the grantor's spouse) becomes an "income withdrawal beneficiary" after the grantor's death.
  - If this technique is used, the grantor should also bequeath any outstanding notes in which the grantor is the creditor to the "income withdrawal beneficiary."

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- Considerations for all BDOT techniques.
  - Avoiding a wealth transfer tax caused by lapse of a general power.
    - In order to receive the lapse of power transfer tax protection of IRC Sections 2041(b)(2) and 2514(e)(2), it is important that the withdrawal power applies against all of the income earned by all of the BDOT trust assets and can be satisfied from the trust's accounting income, sale proceeds of the corpus of the BDOT trust, and corpus of the BDOT trust.
    - Because the beneficiary has a right to withdraw trust income, IRC Section 2036(a) could apply to a contribution to the trust by the beneficiary other than a bona fide sale for full and adequate consideration.
    - It is therefore important that any withdrawable, but untaken, BDOT funds be protected from being considered a contribution by the beneficiary of the BDOT for transfer tax purposes.
    - The requirements under the tax law for those withdrawable, but untaken, BDOT funds to not be considered a transfer for transfer tax purposes are: (i) those BDOT funds cannot exceed more than 5% of the value of the property of the BDOT; (ii) those BDOT funds could have been paid from the entire property, or proceeds from the property, of the BDOT, and (iii) creditors cannot reach those BDOT funds after the right to withdraw them expires. See below for a discussion of the third requirement of whether creditors can reach those fund.
  - Adverse transfer tax consequences if creditors can reach BDOT assets.
    - Almost all states have legislation that protects against the BDOT beneficiary's creditors reaching the withdrawable, but untaken, BDOT funds. Not only do the states that permit self settled trusts protect against those potential creditors, but almost all states have legislation that protects against creditors reaching lapsed withdrawals that are 5% or less of the value of the corpus of a trust. Secondly, a BDOT could be drafted to allow an independent trustee or a protector to remove the withdrawal power that is inherent in a BDOT trust structure in future years.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- Of course, independent of creditor rights considerations, a sale for inadequate consideration by the withdrawing beneficiary will include the full value of the BDOT at the withdrawing beneficiary's death minus the original value of the note receivable because of the withdrawing beneficiary's retained income rights. See IRC Sections 2036(a)(1) and 2043. In order to avoid the consequences of a sale for inadequate consideration, strong consideration should be given to the BDOT beneficiary using a defined value allocation assignment or a defined dollar transfer when he makes the sale.
- The sale of assets to a BDOT has most of the considerations of a LAIDGT or SIDGT, with the following exceptions,
  - There is less danger that the sale to a BDOT will be a taxable gift because of the presence of the seller's beneficial interest and special power of appointment over the BDOT, may make the gift an incomplete gift.
  - The disregarded income tax status can remain longer because of the seller's beneficial interest in the trust, which is not the case with the SIDGT or LAIDGT techniques.
  - There may be a greater opportunity to convert the retained note to a private annuity.
- It may be important to have an independent trustee of the BDOT whose only power is to remove the withdrawal beneficiary's power to withdraw net taxable income for a future year or years.

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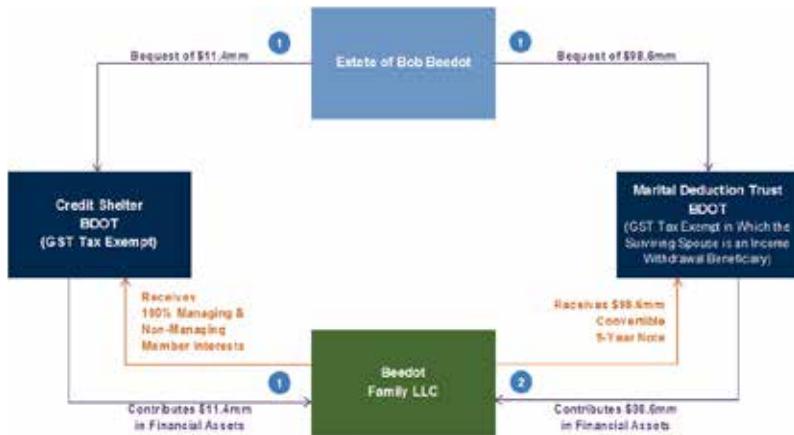
**Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)**

Private Wealth Management



- Post-mortem uses of a sale to an LLC owned by a BDOT.

- The technique is illustrated below:



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**Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)**

Private Wealth Management



- Income tax and basis enhancing advantages of the technique.
  - There is a step-up in basis of the deceased spouse's assets at his death.
  - There is an opportunity through using borrowing strategies from third party lenders for the surviving spouse to increase the basis of the family's assets during her lifetime.
  - All of the income tax and basis enhancing advantages of creating an IDGT are present with this technique.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- Transfer tax advantages of the technique.
  - Significantly more assets may be passed to the next generation by using this technique than using the exemption to fund a credit shelter trust that is taxed as a complex trust and a QTIP marital deduction trust that is taxed as a complex trust.
  - The surviving spouse's rights with respect to assets owned by the QTIP marital deduction trust and the credit shelter trust, and cash flows produced by those assets, are substantial.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- Considerations of the technique.
  - This technique has the same considerations as the creation of a BDOT and a sale to an LLC owned by a BDOT.
  - Like all leverage techniques, if the underlying assets stay flat or decline there is not any advantage to the technique and to the extent a gift tax exemption is used, the technique operates at a disadvantage, unless gross estate inclusion can be toggled on in order to restore gift tax exemption.
  - The QTIP marital deduction trust must also give the surviving spouse the right to withdraw all the trust's accounting income for life in addition to giving the surviving spouse the right to withdraw the net taxable income for life.
    - A spouse's right to withdraw accounting income satisfies the regulations applicable to marital trusts, including QTIP trusts.

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**Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)**

Private  
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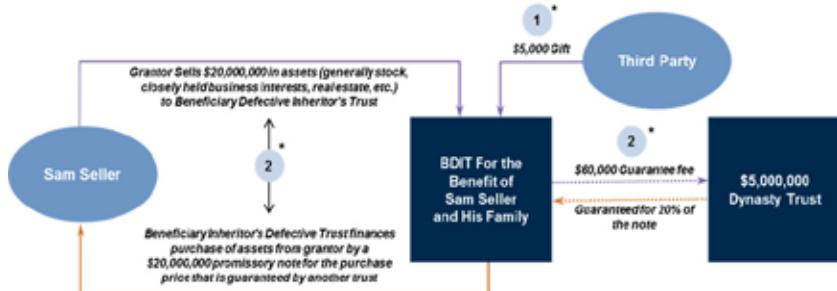


▪ Sales to BDITs.

– What is the \$5,000 BDIT guaranteed sale technique?

- A BDIT is a trust that is a grantor trust, not as to the trust's settlor (the "Settlor") but as to a trust beneficiary (the "beneficiary"). That is, the trust is specifically designed not to trigger any of IRC Sections 673, 674, 675, 676, 677 or 679, but intentionally to trigger IRC Section 678. The BDIT is an IRC Section 678 trust because of operation of IRC Section 678(a)(2).

– The technique is illustrated below:



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**Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)**

Private  
Wealth  
Management



▪ Advantages of the \$5,000 BDIT guaranteed sale technique.

- If the technique works, it has many of the same advantages as the sale to a grantor trust with the additional exit strategies of the transferor not only having access to the cash flow from the note, but also having access to the cash flow of the trust for his or her support and maintenance.
- Additionally, if the technique works, the transferor has the ability to change his or her mind as to future stewardship goals through the power of appointment mechanism.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- Transfer tax considerations of the \$5,000 BDIT guaranteed sale technique.
  - Does the Guarantee Fee Have Substance?
    - There is considerable pressure on the technique because of the need to pay the guarantee fee to the third party. A guarantee fee is probably necessary because the guarantor trust may not be the remainder beneficiary of the BDIT. The IRS may question the substance of any guarantee fee in the hypothetical transaction illustrated above because of the significant ratio of that guarantee fee in comparison to the beginning corpus of the BDIT.
    - It seems open to the IRS to argue that the beneficiary should be treated as the transferor for estate tax purposes of any property which the beneficiary, rather than the settlor, transfers to the BDIT, whether the beneficiary's transfer is a gift or a sale.
  - Estate tax considerations because of potential application of IRC Sections 2036 and/or 2038 with the \$5,000 BDIT guaranteed sale technique.
    - Unlike a conventional sale to a grantor trust in which the seller does not have a retained interest or power over the trust, under the \$5,000 BDIT Guaranteed Sale Technique, the seller is also a beneficiary of the BDIT and will have a retained interest or power, which will trigger IRC Sections 2036 or 2038, unless an exception applies.
    - Under the "parenthetical exception" contained in both IRC Section 2036 and IRC Section 2038, these provisions do not apply "in case of a bona fide sale for an adequate and full consideration in money or money's worth."
    - The application of the parenthetical exception under IRC Sections 2036 and 2038 requires not only that the transfer be for "full consideration," but that it is "a bona fide sale". In the family partnership context, courts have held that the "full consideration" and "bona fide sale" requirements are two separate tests.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
Wealth  
Management



- It seems essential that the sale be for full consideration for the BDIT to achieve its goal of keeping trust property out of the selling beneficiary's gross estate.
- As a consequence, the beneficiary/seller should consider a defined value assignment and the filing of a gift tax return that discloses the sale. However, even if the sale is reported on a gift tax return that meets the adequate disclosure requirements of Treas. Reg. § 301.6501(c)-1(f) and the gift tax statute of limitations runs, the IRS may not be barred upon the beneficiary's death from asserting "inadequacy of consideration" for purposes of IRC Section 2036 and 2038. Adequacy of consideration is a "valuation issue" rather than a "legal issue." Treas. Reg. § 25.2504-2(c), Ex. (3). An estate tax regulation provides that for transfers after August 5, 1997, the running of the gift tax statute of limitations bars any adjustment to the value of a prior gift, and this rule "applies to adjustments involving all issues relating to the gift, including valuation issues and legal issues involving the interpretation of the gift tax law." Treas. Reg. § 20.2001-1(b).
- Treas. Reg. § 301.6501(c)-1(f) provides that "if an incomplete gift is reported as a completed gift on the gift tax return and is adequately disclosed, the period for assessment of the gift tax will begin to run when the return is filed, as determined under IRC Section 6501(b)."
- However, it is not clear that the regulation, which applies when "an incomplete gift is reported as a completed gift," will apply to a return that reports the transfer as a sale for full consideration but says nothing about whether any value later determined to be in excess of the consideration is a complete or incomplete gift. That is the way most such gift tax returns will read, because the beneficiary typically will want to preserve the "incompleteness" argument as to any gift if the consideration is found inadequate.
- Additionally, the gift tax return filing will not start the statute of limitations running on an estate tax issue of whether the sale is a "bona fide sale" because that is a legal issue, which may only be determined on the taxpayer's death.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

Private  
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- Income tax considerations with the \$5,000 BDIT guaranteed sale technique.
  - In general.
    - The BDIT must remain a grantor trust during the beneficiary's life, or at least while any note is outstanding, in order to circumvent a capital gain on the sale (or as installments are paid), income tax on interest payments, and (possibly) adverse consequences upon loss of grantor trust status under Treas. Reg. § 1.1001-2(c), Ex. (5).
    - To achieve grantor trust status under IRC Section 678, initially the beneficiary must have over the trust "a power exercisable solely by himself to vest the corpus or the income therefrom in himself." IRC Section 678(a)(1).
    - If left in place, such a power would cause the trust property to be includable in the beneficiary's gross estate under IRC Sections 2036 and 2038, or under IRC Section 2041, whichever is viewed as applicable. Thus, this power must be cut down before the beneficiary's death without either (1) losing grantor trust status, or (2) causing the beneficiary to be treated as the transferor for estate tax purposes.
    - Once the beneficiary acquires a power described in IRC Section 678(a)(1), IRC Section 678(a)(2) provides that the trust continues to be a grantor trust after the power holder "has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of IRC Sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof."
  - It is necessary for the settlor of the BDIT to steer clear of grantor trust status.
  - Release vs. lapse.
    - One issue with respect to any BDIT in which there is a lapse of a withdrawal right, is whether IRC Section 678(a)(2) applies when the power is cut down by a lapse rather than a release. If a lapse occurs pursuant to the terms of the trust, can the power holder be said to have "partially released or otherwise modified" the power? The private rulings imply that the answer is yes.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

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- Partial release or other modification.
  - Assuming a lapse can qualify as a release or other modification, the next issue with respect to any BDIT in which there is a lapse of a withdrawal right is whether a power that has lapsed completely (either all at once or in stages over time) remains one described in IRC Section 678(a)(2), given the statute's requirement that the IRC Section 678(a)(1) power have been partially released or otherwise modified" (underscoring added).

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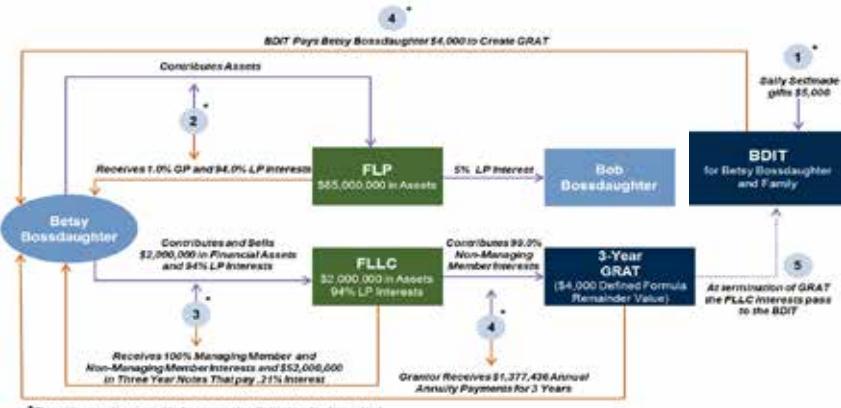
**Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse  
(Continued)**

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- Alternative to the BDIT guaranteed sale technique and the substantial hanging power created BDIT: the technique of a \$5,000 BDIT jointly creating a GRAT or a LAGRAT with the BDIT providing the consideration for the remainder interest (the “BDIT remainder purchase”) technique.

- What is the BDIT remainder purchase technique? The technique is illustrated below:



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**Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse  
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- Advantages of the BDIT remainder purchase technique.
  - The assets of the BDIT, if the transferor is not a deemed donor under equitable principles, will not be subject to estate taxes in the transferor's estate.
  - Avoids capital gains tax consequences on the sale of assets to the trust.
  - Has the advantage of allowing Betsy access to cash flow from note payments, and as a beneficiary of the BDIT.
  - The transferor has flexibility to change the future beneficiaries of the trust through the exercise of a special power of appointment.
  - Has the potential to avoid gift tax surprises.
  - Appreciation will be out of the transferor's estate.

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**Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)**

Private Wealth Management 

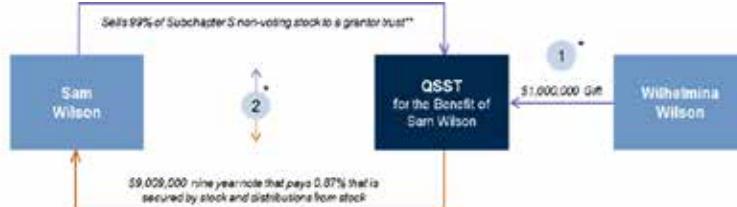
- Considerations of the BDIT remainder purchase technique.
  - In order for the full and adequate consideration exception under IRC Section 2036 to apply, the remainder interest of the GRAT that is sold may need to have a substantive value much greater than \$4,000.
  - This technique could also be utilized with a BDOT jointly created GRAT with the BDOT, or Spousal Grantor Trust, providing the consideration for the remainder interest.
    - The above consideration of a BDIT not having enough substantive value in order to avoid IRC Section 2036 may not be present with a BDOT, or a Spousal Grantor Trust, if it has substantial value. The BDOT, or Spousal Grantor Trust, could be designed to be a generation skipping trust.
  - Need to file a federal gift tax return.
    - A federal gift tax return needs to be filed in order to determine if there should be any adjustments with the GRAT and to get the statute of limitations running. There will be an expense in connection with filing the federal gift tax return and with the necessary appraisals attendant with the technique.
  - State income tax considerations.
    - There may be state income tax considerations on the sale of any appreciated assets to the FLLC. There also may be state income tax consequences in selling the remainder interest of a GRAT to the BDIT.
  - Step transaction doctrine could apply.
    - If the IRS can demonstrate, because of the thin capitalization, the \$4,000 payment should be ignored, then under other equitable principles it may be able to establish the creation of the BDIT lacks independence, and the deemed grantor of the trust will be the beneficiary.

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**Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)**

Private Wealth Management 

- Freeze Planning with Subchapter S Stock and a Qualified Subchapter S Trust.
  - What is the technique? The technique is illustrated below:



- IRC Section 678 ownership of S corporation stock by beneficiary.
  - Under IRC Section 1361(d)(1)(B) the transferor (as a beneficiary of the QSST) will be treated as the owner of the subchapter S stock held in trust under IRC Section 678(a).

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

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#### — What is a QSST?

- A QSST is a trust that has only one income beneficiary and any corpus distributed during the life of the current beneficiary may only be distributed to that beneficiary. After an election is made by the beneficiary, the beneficiary is taxable on the taxable income of any subchapter S stock that is owned by the trust as if the trust is a grantor trust to the beneficiary under IRC Section 678(a).
- Disregarded sales of stock to a QSST.
  - Can the distributions from the subchapter S corporation stock owned by the QSST, which are collateral on the transferor's note, be used to retire both the principal and interest of the note on which the QSST is the obligor?
  - Clearly interest on a note is a charge against the income of a trust for trust accounting purposes and should be paid by the trustee of the QSST.
  - The distributions on the purchased subchapter S stock to the QSST can also be used by the trustee of the QSST to retire the principal on the note, if the distributions are security for a note on which the QSST is the obligor.
  - There may need to be an equitable adjustment between the principal and income of the trust when the distributions from purchased subchapter S stock are used by the trustee of the QSST to retire principal of the debt used for that purchase.

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### Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

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#### ▪ Advantages of the technique.

- A QSST can be substantively funded, which may be more advantageous than a sale to certain IRC Section 678 techniques (i.e., the BDIT), which can only be initially funded with \$5,000.
- A QSST circumvents federal capital gains tax treatment on the sale of the subchapter S stock.
- There is not any concern about the effect of any lapse of withdrawal rights.
- It has the advantage of allowing the seller to be a beneficiary of the trust and have a power of appointment over the trust.
- It has the potential of mitigating gift tax surprises.
- Appreciation will be out of the seller's estate.
- Flexibility goals may be met.
- Finally, the income beneficiary of the QSST will have access to the cash flow of these trusts as the sole income beneficiary of the trusts.
- The estate tax savings of the technique could be substantial.
- The high-income trust income tax rates may be avoided if the beneficiary is in a lower bracket.
- The subchapter S corporation could reinvest its earnings, which would lower the income beneficiary's distributions and increase the remainder value.

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## Some of the Best Creative Tax Planning Techniques for Beneficiary Grantor Trusts That Are Created By a Third Party That is Not the Beneficiary's Spouse (Continued)

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- Considerations of the technique.
  - There may need to be substantive equity in the trust from prior gifts (is 10% equity enough?) before the sale is made.
  - The disadvantages of utilizing a subchapter S corporation.
  - Need to file a federal gift tax return.
  - Federal income tax considerations.
  - State income tax considerations.
  - Could lose the benefits of using the gift tax exemption.
  - Step transaction doctrine.
  - The transferor is the only beneficiary of the trust.

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## Biography

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### Biographies

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Stacy joined the firm to expand the advisory team working with Private Wealth Management clients. He currently works with private clients and their own advisors with their strategic wealth management plans, combining a variety of income tax, estate planning and gifting techniques. Prior to joining Goldman Sachs in October 2000, Stacy was a senior partner with Baker Botts, L.L.P. in Houston, Texas. Stacy received his B.S. (with Honors) from Washington and Lee and his J.D. from The University of Texas (with Honors). Stacy's professional associations include: Member of the International Academy of Estate and Trust Law; Fellow of the American College of Trust and Estate Counsel (Regent for 1992/1998 term); Member of the American Bar Association (Supervisory Council Member of the Real Property, Probate and Trust Law Section from 1990-1998); Member of the Texas Bar Association (Texas Bar Foundation Fellow); Member of the Houston Bar Association (Houston Bar Foundation Fellow). Stacy is listed in Who's Who in America and was selected to receive the Marquis Who's Who Lifetime Achievement award in 2017. Stacy is also listed in The Best Lawyers in America (Woodward/White). He has been listed in Town & Country and in Bloomberg Personal Finance as one of the top trust and estate lawyers in the U.S. Stacy was selected as one of the ten initial recipients of the Accredited Estate Planner® award of the Estate Planning Hall of Fame® of the National Association of Estate Planners and Councils (2004). He was chosen as the 2018 Hartman Axley Lifetime Service Award recipient of the National Association of Estate Planners and Councils. He was recently named one of the "Top 100 Wealth Advisors" to ultra-high net worth individual clients in the United States by Citywealth magazine. Articles about Stacy's estate planning ideas have also been featured in Forbes and Fortune magazines. Stacy is a prominent lecturer throughout the country.

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