COMMUNICATING PLANNING TECHNIQUES IN AN UNDERSTANDABLE MANNER USING SPREADSHEETS, COMPARISONS AND SHORT SUMMARIES

Jerome M. Hesch
Director, Notre Dame Tax & Estate Planning Institute
Adjunct Professor, University of Miami School of Law
Graduate Program in Estate Planning

Southern Arizona Estate Planning Council
The Arizona Inn
Tucson, Arizona
December 12, 2012

Jerome M. Hesch, Esq. is Of Counsel to Berger Singerman, P.A., Miami, Florida, and is Special Tax Counsel to Carlton Fields, PA, Miami, Florida and Oshins & Associates, LLP, Las Vegas, Nevada. He is the Director of the Notre Dame Tax and Estate Planning Institute, scheduled this year on October 17 and 18, 2013 in South Bend, Indiana, a Fellow of ACTEC and was recently elected to the National Association of Estate Planners and Councils Hall of Fame. His publications include Tax Management Portfolios and a co-authored law school casebook on Federal Income Taxation, now in its fourth edition. He received his B.A. and M.B.A. degrees from the University of Michigan and a J.D. degree from the University of Buffalo Law School. He was with the Office of Chief Counsel, Internal Revenue Service, Washington, D.C., from 1970 to 1975, and was a full-time law professor from 1975 to 1994, teaching at the University of Miami and the Albany Law School, Union University. He is currently an adjunct professor at the Florida International University Law School and the Graduate Program in Estate Planning at the University of Miami.

Abstract *The first portion of this afternoon's presentation will describe the many goals of an estate plan and analyze how the menu of estate planning techniques can or cannot accomplish these goals. The remainder of the presentation will illustrate how to communicate in a* ***brief****, yet* ***understandable*** *manner the dollar amounts that can be saved by using a particular technique. Examples allow the estate planning professional to explain how a particular technique actually works without having to use the legal and technical terms we so often take for granted. Hopefully, if you can show the potential client how much tax you can save, they will proceed with their estate plan.*

I. Overview

Much has been said about taking advantage of the currently available $5,120,000 gift tax exemption for the remainder of the 2012 year. The first topic I will address is the financial problems that can occur in the distant future by making the $10,000,000 in tax-free gifts to grantor trusts and why certain individuals should not make maximum taxable gifts during the 2012 year.

There have been many articles and programs describing advanced transfer tax planning techniques that are not commonly used or that you may not be totally conversant. The purpose of this afternoon's presentation is not to describe the legal technicalities of an estate planning technique. Instead, the emphasis will be on COMMUNICATION. An often overlooked function of our profession is to describe what each of these techniques can accomplish, their advantages, their limitations and which technique, or combination of techniques, is most appropriate for a particular client situation. As part of our analysis, we will use numerical examples designed to show the clients what they really want to know, that being *"how much will I save in taxes?*" And, the clients want to learn about the potential tax savings in the first five minutes of your meeting. Furthermore, using numerical examples allows the advisor to explain how a particular technique accomplishes its tax saving objective.

This afternoon, I also hope to sensitize you that large estate tax exemptions (hopefully at least $3,500,000 per person in 2013 and subsequent years) and the unlimited marital deduction are ideal vehicles to eliminate potential income tax gains. What has been lost in the rush to take advantage of the $5,120,000 per person gift exemption that may expire by the end of the 2012 year is that for all gifts the transferee's income tax basis is a carryover basis and that gifts cannot take advantage of the income tax-free step-up in basis at death that occurs for assets included in the decedents gross estate even if there is no estate tax because of exemptions and the marital deduction.

We will also examine how large gift tax exemptions can be used to increase the effectiveness of estate planning techniques. We will analyze how large gift tax exemptions can be used in ways that have not been generally discussed. Another purpose of today's presentation is to evaluate how to take full advantage of the available estate planning techniques in the future and increase their estate tax savings in an environment where the gift and estate tax exemption may be far less than the current $5,120,000 level.

In order to accomplish these objectives, it is essential that one understands not only the wealth-shifting principles estate planning techniques use, but that the goals of estate planning go far beyond mere transfer tax savings. In order to effectively evaluate the application of these principles and goals, I will briefly describe these principles and goals.

II. Goals other than transfer tax-free wealth depletion

When evaluating one's estate tax and income tax goals, the estate planning professional must make sure that in maximizing the estate tax and income tax savings, the estate planning professional does not lose sight of the individual's personal and financial goals and must make sure that these goals are coordinated. The estate planning professional must be sensitive to the possibility that the focus on saving transfer taxes may adversely affect the ability to satisfy the individual's other goals. If it is not possible to completely satisfy all of an individual's tax, financial and personal goals, compromise is necessary. Furthermore, given the litigious nature of our society, the estate planning professional must incorporate as part of any planning proposal the protection of assets, not only from the individual's potential future creditors, but the future creditors of the beneficiaries of any trusts.

Even though the primary goal of an estate planning technique is minimization of the transfer taxes, the estate planning professional is well aware that most of the commonly-used estate planning techniques cannot simultaneously achieve all of the goals an individual desires to accomplish.

The following are the main goals:

1. *Control over beneficial enjoyment:* The ability to decide how the income and principal from the transferred assets are to be disposed among junior family members.

2. *Management control:* Investment decisions over the transferred assets.

3. *Beneficial access:* Retaining the use and enjoyment of transferred assets. The individual's economic access to the income and principal from the transferred assets and the use and enjoyment of the transferred assets.[1]

4. *Asset protection:* The protection of the transferred assets from creditors for both the individual and the individual's family.

5. *Reduce transfer taxes:* The transfer of assets from generation to generation with little or no transfer taxes.

6. *Flexibility in the future:* Since planning techniques use irrevocable trusts that are drafted to set forth specific directions for the administration of those trusts in the future, especially after the creator of that trust has died, those specific directions may cause future problems. Especially with

---

[1] The individual who creates a trust can indirectly receive the financial benefit of trust assets if a permissible beneficiary of the trust is the creator's spouse (commonly referred to as a "spousal limited access trust," a "SLAT"). Furthermore, if an individual uses a trust created by another person for his own estate planning, that individual can directly receive the financial benefit as a permissible beneficiary.

the popular use of dynasty trusts today, a significant concern that needs to be addressed is how to draft into the trust the necessary flexibility where it is virtually impossible to predict what will occur in the future, not only with respect to the needs of the trust's beneficiaries, but also the financial performance of the trust. How can this flexibility be achieved by the use of giving the trustee more specific guidance, coupled with discretionary powers, special powers of appointment given to trust beneficiaries, the appointment of trust protectors and the new world of state decanting statutes. The flexibility analysis will be covered by several of the speakers during the formal presentations tomorrow and Friday. They intend to point out some of the problems that may arise with dynasty trusts for the third, fourth and subsequent generations.

The wealth shifting techniques designed to meet one or more of the above goals have been part of the planning process for years. When you think through the arsenal of the typical estate planning techniques, you realize that if the client is the creator of the trust receiving the transferred assets, at least two, and maybe three, of these goals cannot be satisfied. And, if the transfer results in a junior family member owning the transferred assets outright, the only goal that can realistically be satisfied is minimizing the transfer taxes. Passing on the individual's wealth in trust, as opposed to individual ownership, is always preferable since it will enhance the recipient's benefits and if it is transferred to a generation-skipping trust domiciled in a "trust friendly" jurisdiction, the "in trust" benefits can be secured for succeeding generations.

You also know that a beneficiary of a trust created by another can be given some control by using a special power of appointment, that the beneficiary's creditors cannot go after trust assets and that the trustee can make discretionary distributions to a beneficiary without exposing trust assets to inclusion in the beneficiary's gross estate.

Limits on the creator of a trust. If the individual is able to transfer assets to a trust the individual created at little or no transfer tax exposure, such as a $5,120,000 taxable gift in 2012 to a trust for the benefit of the individual's spouse and the individual's descendants, control over the beneficial enjoyment of trust assets and direct financial enjoyment of trust assets (goals 1 and 3) cannot be satisfied. The creator of a trust can retain control of the investment decisions of trust assets in the role of a trustee with fiduciary duties. Furthermore, when a family limited partnership is used in connection with the gift, an individual can retain control over investment decisions as the general partner of the limited partnership. The general partner can also control the timing of distributions from the family limited partnership to its partners. However, an individual's economic access to the income from the transferred assets, or the use of the transferred assets, will result in the entire value of the transferred assets being included in the individual's gross estate at death. Likewise, the ability to decide how the income and principal from the transferred assets are to be disposed among junior family members will result in estate taxation upon death.

Asset protection planning received significant attention when advisors took advantage of the "charging order" remedy to protect client assets.[2] In other words, when you owned your assets in a partnership, your creditors cannot attach the underlying partnership's assets. The creditors cannot force the partnership to make distributions. And creditors can only reach distributions from the partnership if and when made. And if they wanted even more protections, estate planners used foreign asset protection trusts to protect assets.[3] In a basic asset protection trust scenario, the individual establishes a trust for his or her benefit. But because of foreign law and spendthrift provisions, the trust is not subject to the creditor claims of the grantor. In 1997, the first domestic asset protection trust laws were enacted.[4] Since 1997, 11 other states have enacted asset protection trust legislation.[5] Asset protection trusts are often used in combination with the FLPs or family limited liability companies to combine the protections of the charging order with that of the trusts while maintaining some level of client managerial control.

---

2 See, Section 504, Revised Uniform Partnership Act of 1994; Section 504, Uniform Limited Liability Company Act of 1996; Section 703, Uniform Limited Partnership Act of 2001.

3 Federal bankruptcy courts have great disdain for foreign asset protection trusts. See, *FTC v. Affordable Media, LLC*, 179 F.3d 1228 (9th Cir. 1999) ("Anderson case") (where the judge held the beneficiary of the trust in contempt after the trustee would not satisfy a judgment against him.)

4 Alaska being the first jurisdiction to pass such legislation on April 2, 1997. A.S. §§ 13.36, 34.27.051, 34.40.110-115.

5 Among the other states are: Hawaii, Missouri, New Hampshire, Oklahoma, Tennessee, Utah, Wyoming, **Nevada**, Delaware, Rhode Island and South Dakota. Nevada is the only US jurisdiction that would meet the requirements for a total spendthrift trust jurisdiction. Beware of Sec 548(a)(1)(e) of the Federal bankruptcy statue for the "10 year" clawback rule for fraudulent transfers that trump state law.

III. Underlying principles used by estate planning techniques.

The primary purpose of all estate planning techniques is to shift value from the senior generation to junior generations without exposing the wealth transfer to the gift tax, the estate tax, and for the very wealthy, without exposure to the generation skipping transfer tax. Because of the way estate planning techniques are designed, the longer one survives after the technique has been put in place, the greater are the gift, generation skipping transfer and estate tax savings.[6] Of all the available estate planning techniques, only valuation discounts provide significant transfer tax-free shifting of wealth if the individual only survives for a relatively short period of time after implementation of an estate plan.[7] Therefore, it is never too soon to consider estate planning. The same technique will yield far greater benefits if put in place by someone age 60 as opposed to the same technique used by someone age 75.

There are two primary reasons why the estate tax savings created by a planning technique are greater the younger one starts. The first is that many of the estate planning techniques shift wealth annually. The longer one lives, the more years the technique has to work. The simplest technique is to make the maximum available annual exclusion gifts each calendar year. Gifts of the annual exclusion amount are not treated as taxable gifts, and they do not use gift tax exemptions under the applicable credit. The compounding advantage is that individuals are entitled to make annual exclusion gifts to the same persons each year. If one can transfer $52,000[8] free of all gift taxes each year, the aggregate amount of tax-free gifts increases every year. The second is that the initial tax benefit from each transfer to a trust compounds as the wealth transferred to the trust builds up. This is similar to the way tax deferred income accumulating in an IRA compounds as time goes by.

Every estate planning professional is familiar with the menu of available estate planning techniques, ranging from the simple through the complex. But familiarity with the menu of available estate planning techniques is but one small part of the process. The preparation of a complete estate planning proposal not only requires familiarity with the menu of available estate planning techniques, but the analytical ability to evaluate each individual's unique situation in order to decide upon the most appropriate estate planning technique, or combination of estate planning techniques, to use for that particular individual. Furthermore, a complete estate planning analysis requires that the estate planning professional not only consider how to maximize the transfer tax savings, but also evaluate the potential for income tax savings and take into account the individual's station in life and personal and financial objectives.

---

6 Since the gift tax, the estate tax and the GST tax are all transfer taxes, we sometimes collectively refer to all three taxes as the transfer taxes.

7 Disposing of an asset shortly before it is expected to spike in value, such as an anticipated IPO, is another short term solution.

8 Assumes four $13,000 annual gifts to four individuals. And, if the donor is married, the split gift election doubles that amount to $104,000 each calendar year. Over a ten-year period the total would be $1,040,000. The annual exclusion for the 2013 year will be $14,000.

As part of the communication process, the individual who must decide whether or not to proceed with the recommended planning technique needs to first understand, not the technique itself, but the basic wealth transfer concepts the technique uses to achieve the transfer of wealth free of the gift, GST, and estate taxes. Thus, an important goal is to communicate in an understandable manner the wealth shifting concept or concepts being proposed. In this regard, there are only a few wealth transfer concepts all estate planning techniques use. These wealth shifting concepts are:

1. **Exemptions and exclusions**. Transfers that that would otherwise be taxable gifts or that would result in taxable estates, but are exempted or excluded from the gift, estate and generation-skipping transfer ("GST") taxes. Included are annual exclusion gifts, direct payment of tuition and medical costs, the use of the applicable credits (commonly referred to as the unified credit) and the use of GST exclusions.

2. **The estate freeze**. Current transfer of assets expected to increase in value.

3. **Valuation discounts.** Creating factors that make a portion of the value of assets disappear such as lack of control and lack of marketability.

4. **Financial leverage**. The ability to borrow at a low interest rate and invest the borrowed funds at a higher rate of return.

5. **Grantor trust status.** Allows the creator of a trust to pay the income taxes on the trust's taxable income. The grantor's payment of the income taxes on the trust's taxable income without any gift taxes allows more value to accumulate in the grantor trust.[9] We feel that over a long period of time, the grantor's payment of the income taxes on the trust's income can deplete more wealth than discounts and financial leverage combined.

6. **Compounding**. Allowing the transfer tax benefits to accumulate over a long period of time. The longer a technique is in place, the greater are the transfer tax benefits.

---

9 If one desires to take advantage of grantor trust treatment, this may influence the decision to make a transfer in trust rather than outright to an individual.

A. Exemptions and exclusions for transfers that that would otherwise be taxable gifts or result in taxable estates but are exempted from the gift, estate, and GST taxes.

Each year an individual is allowed to make gifts up to a certain amount that are not treated as gifts for purposes of the gift tax. These gifts are commonly referred to as *annual exclusion* gifts.[10] For the 2012 year, every individual donor is permitted to make annual exclusion gifts of $13,000 every calendar year and can make separate annual exclusion gifts for each separate donee. For this purpose, a husband and a wife can each make their own annual exclusion gifts. For example, an individual with three children can give each of the three children $13,000 every year, for a total of $39,000 each year. And a married couple with three children can gift up to $78,000 this year and another $78,000 in each subsequent year. None of these annual exclusion gifts will be treated as a taxable gift. Since the annual exclusion is not limited to the donor's descendants or other family members, the annual exclusion applies to a donee that is not a family member or is a trust for one's descendants; provided that the gift in trust is a gift of a present interest.[11] Suppose a married couple has three adult children who are all married and each child has three of their own children. The potential donees are the three children, the three son-in-law or daughter-in-law and the nine grandchildren. There are 15 separate donees and two separate donors. Each donee can receive $26,000 in annual exclusion gifts every year. Thus, there is a total of $390,000 in tax free annual exclusion gifts every year. Over a 20-year period, that would amount to $7,800,000 of aggregate annual exclusion gifts.

There is another exemption from taxable gifts. Any person who directly pays the tuition at any educational institution, even a private high school, for any individual, or the medical expenses of any individual, does not have to treat that direct payment as a gift.[12] Assume that the grandparents have a grandchild just starting a private college where the annual tuition is $42,000 and the costs of room, board, entertainment and travel are another $26,000, a total of $68,000. The tuition paid directly by the grandparents is not a gift. Although the remaining $26,000 is a gift, it is not a taxable gift because the grandparents have two $13,000 annual exclusions.[13]

---

10 Section 2503(b). For purposes of this article, all references to the Code are to the Internal Revenue Code of 1986, as amended.

11 Section 2503(b)(1).

12 Section 2503(e).

13 Annual exclusion gifts under Section 2503(b) and payment of tuition and medical costs under Section 2503(e) are not treated as GST transfers only if the transfer is a direct skip. Section 2642(c). Annual exclusion gifts to a trust with non skip persons as beneficiaries must use GST exemptions, necessitating the filing of a gift tax return.

B. Gifts of assets expected to increase in value

The gift and estate taxes are transfer taxes on the value of assets transferred at the time of the transfer. Once an asset is transferred, it is then owned by the transferee, and any subsequent appreciation in value and the income generated by the gifted assets cannot be subject to transfer taxes. Thus, one should consider making a gift of assets that are expected to increase in value and assets that are producing a substantial amount of income. Once the ownership of an asset has been transferred, the donor is no longer the owner of the asset, and any subsequent appreciation in value belongs to the new owner. In today's environment, where values of stocks and real estate are unusually depressed, and can reasonably be expected to return to their prior values over time, one should consider making a gift of these assets, at least up to $5,000,000 as there is no gift tax on the first $5,000,000, ($10,000,000 for a married couple's taxable gifts.) Furthermore, since any income generated by the gifted asset now belongs to the new owner, that income is not subject to any gift taxes.

C. Discounts that make value disappear

Many assets are worth less than what the asset would cost to replace because of two factors. The first is lack of control. If an individual is a minority owner of an asset, the minority owner cannot decide to sell the asset without the other owners who have voting control agreeing to a sale. Therefore, the value of the minority interest is not generally equal to the minority owner's pro rata portion of the value of the entire asset. If an individual owns a 25% minority interest in a building valued at $1,000,000, the minority owner's 25% interest is worth something less than $250,000. Thus, the 25% minority interest must be discounted for this lack of control. This lack of control can occur even if the individual owns more than a 50% interest in an asset. This is accomplished by transferring an asset to an entity such as a limited partnership, an S corporation or a limited liability company and creating voting and non-voting interests in that family entity. In the typical family limited partnership, the limited partner has a 99% interest and the general partner has only a 1% interest. Since the limited partnership interest has no voting rights, all of the control is in the general partner even though the general partner has a right to only 1% of the partnership's assets and 1% of its profits.

The second factor leading to a discount is called lack of marketability. If an asset is not a publicly-traded security, it may take some time to actually sell the asset. Thus, the amount one can expect to sell an asset for may not be received until a potential buyer is found and then committed to purchase the asset. And the ability to sell the asset may be uncertain. The possibility that it may take a long time to sell the asset and the possibility that the asset may not be sold for a price equal to its hoped for value must be taken into account. This lack of marketability leads to a further valuation discount. When both lack of control and lack of marketability are taken into account, it is not unusual for the valuation discount to range from 20% to as high as 45% and sometimes even higher. The only assets that are not discounted for lack of control and lack of marketability are marketable securities, such as stocks that are traded on a listed stock exchange. Because one can sell stocks in a public company at or near the price listed on the stock exchange and because the sale can occur immediately after putting in a sell

order with their stock broker, marketable securities have no such discount from their price on a listed stock exchange. However, if an individual transfers marketable securities to a family limited partnership in exchange for a limited partnership interest, the individual no longer has any control because a limited partnership interest has no voting rights. And, there is a lack of marketability because a limited partnership interest in a family limited partnership is not readily marketable. Thus, one can create valuation discounts for assets that would not have such discounts if held directly by contributing the marketable assets to a family limited partnership in exchange for a limited partnership interest. By creating a valuation discount for an asset, the amount of the discount can essentially be transferred without any gift or estate taxes by using any of the available estate planning techniques. For example, if a married couple who own marketable securities valued at $2,666,667 transfers their marketable securities to a family limited partnership in exchange for a non-voting limited partnership interest, it is reasonable to take a 25% discount and value the limited partnership interest at $2,000,000. They can then make a gift of the entire limited partnership interest, reporting a $2,000,000 taxable gift, while essentially transferring $666,667 of value without any gift tax. If the asset is not a marketable security such as an interest in a family business or a real estate investment, then the lack of marketability already exists.

Since discounts are a one-time benefit, over a long period of time, the size of the discount is not as important as the other wealth depletion factors. Thus, to minimize the chances of an IRS audit on the size of the discount, it is recommended that a conservative discount be used in valuing the limited partnership interest, typically equal to the size of the valuation discount the IRS offers in settlement of marketable security FLPs.

D. Financial leverage: The ability to borrow at a low interest rate and invest the borrowed funds at a higher rate of return.

If a person can borrow funds at a low interest rate and invest the borrowed funds at a rate of return greater than the cost of the borrowing, that person can keep the excess of what was earned over the cost of the invested funds. This concept is commonly referred to as financial leverage and is a well-accepted estate planning technique that is also approved by the Internal Revenue Code.[14] For example, a father lends his son $1,000,000 with annual interest payable at a rate of 0.50%, and the entire $1,000,000 is payable at maturity at the end of three years. The son's annual interest cost is $5,000. The son uses the loan proceeds to purchase a corporate bond paying 3½% annual interest with a maturity of 3 years. The son collects $35,000 of interest each year and uses only $5,000 to pay the interest owed to his father. The use of this concept has allowed the son to earn and keep $30,000 generated by the father's funds without the payment of any gift taxes.

---

14 For all loans and seller-provided financing sales, including intra-family loans and sales, the Internal Revenue Code provides for minimum interest rates that must be respected. See Sections 1274 and 7872.

The use of financial leverage is actually sanctioned by several sections of the Internal Revenue Code which provide for minimum interest rates that can be used where there are intra-family loans and intra-family sales. If one provides that the stated interest rate on a note is the minimum interest rate required by the Code, the Internal Revenue Service is required to accept the stated interest rate used for the intra-family loan. And the spread between the cost of funds and the rate of return on the investment of those funds will exist in both low and high interest rate environments because the minimum interest rates the Internal Revenue Service is required to use are always well below market interest rates.

Since many of the commonly used estate planning techniques, such as a GRAT, use interest rates and depend for their success on financial leverage, the use of below market interest rates increases the ability to successfully transfer value without any gift taxes.

An investment that has the best chance of producing a financial leverage benefit is a life insurance policy. What is not generally recognized is that the financial leverage spread produced by an investment in life insurance can be further enhanced if the owner of the life insurance policy can borrow funds from a third-party to pay for all or a portion of the funds needed for the payment of the premiums. In effect, the financial leverage benefits can be increase even more by the use of "premium financing."

E. Grantor trusts allow the senior generation's payment of the income taxes on the younger generation's taxable income.

Planners often use transfers to grantor trusts, such as an outright gift, a grantor retained annuity trust ("GRAT"), the charitable lead annuity trust ("CLAT") and an installment sale to a grantor trust as estate freeze techniques. Although the primary objective of these estate planning techniques is to use financial leverage and shift future appreciation in value to the trust without any gift taxes, a separate wealth shifting benefit arises by the grantor's payment of the grantor trust's Federal and state income tax liabilities relating to the trust's income.

Over a long period of time, the transfer tax-free shifting of value from grantor trust status has a far greater impact than valuation discounts and financial leverage combined.

When there is a transfer to an irrevocable trust and the trust is treated as a grantor trust for Federal income tax purposes, the Internal Revenue Code creates a fiction in that the individual who creates the trust (referred to as the "grantor") is deemed to own the trust's assets and, as the deemed owner of the trust's assets, the grantor must report the

trust's income on the grantor's individual income tax return even though the grantor does not receive a distribution of that income, such as when the income is accumulated or distributed to a trust beneficiary. Accordingly, the grantor must pay the income taxes on the trust's income at the grantor's individual income tax rates. The Internal Revenue Service ruled that the grantor's payment of the income taxes on the grantor trust's income is not a gift for gift tax purposes.[15] Suppose a grantor trust received a taxable gift of $2,000,000, with no gift taxes because the first $2,000,000 of taxable gifts is not subject to gift taxes, and the contributed asset generates $100,000 of ordinary income annually. If the combined state and Federal income tax on this income is $40,000, the grantor is required to pay the income taxes on the trust's income. In effect, the grantor has effectively made a gift-tax free transfer of another $40,000. And, this indirect tax-free gift continues each year that the grantor is living and paying the income taxes on the grantor trust's income.

F. <u>Compounding</u> over a long period of time.

Over a long period of time, the income on the transferred taxes avoided or deferred by the use of these techniques, results in an additional after tax benefit to junior members.

---

15 Rev. Rul. 2004-64, 2004-2 C.B. 7.

IV. The mainstream techniques used to achieve one or more of the above mentioned goals are:

(i) direct gifts to individuals or gifts in trust;

(ii) family limited partnerships ("FLP");

(iii) grantor retained annuity trusts (GRATs);

(iv) qualified personal residence trusts (QPRTs);

(v) charitable lead annuity trusts (CLATs)

(vi) irrevocable life insurance trusts ("ILIT");

(vii) installment sales to grantor trusts ("IDGT")

(viii) private annuity sales to grantor trusts,

(ix) asset protection trusts ("APT");

(x) a beneficiary uses a trust created by another individual (the "BDIT"); and

(xi) Premium financed life insurance (leveraged life insurance)

Often two or more mainstream techniques are combined to enhance the planning. For example, the installment sale to a grantor trust can use limited partnership interests and the grantor trust can be both an ILIT and an APT. Under this technique, the grantor sells a discounted limited partnership interest in a FLP to a grantor trust the grantor created, taking back the trust's promissory note in satisfaction of the entire purchase price. The trust can then use its funds, especially its annual income in excess of its interest obligation, to purchase a life insurance policy. And, the trust can also be structured for asset protection.

Each mainstream technique has its limitations. With the exception of the beneficiary using a trust created by another individual for the beneficiary's estate planning, which has recently come into favor, each of the mainstream techniques has been used in some form for several decades.

If the beneficiary uses a trust created by another individual, typically the beneficiary's parent, the beneficiary can sell a discounted asset to that trust, taking back the purchaser's promissory note in satisfaction of the entire purchase price. In order to avoid having the beneficiary report a taxable gain on the installment sale, the trust is structured so that it is a grantor trust with respect to the beneficiary, not the creator. This type of trust is commonly referred to as a beneficiary defective inheritor's trust ("BDIT"). The BDIT was developed to take advantage of a combination of the virtues of the other strategies, e.g., the freeze component of the IDGT, and the protection from creditors of the APT while eliminating most of the negatives.

Essentially, in a BDIT transaction a trust is created by a parent for the benefit of the parent's descendants. This trust has grantor status, not with respect to parent, but with respect to one of the children. Since that child is not the creator of the trust, the assets in the trust are protected from the creditors of the beneficiaries and from estate tax inclusion in the estates of the beneficiaries.

V. The Financial Danger of Maximizing Taxable Gifts in 2012

At present, clients and their estate planning advisors are contemplating making \$5,120,000 taxable gifts (or twice that amount using the split gift election) before year-end because the gift tax exemption may revert to \$1,000,000[16] starting in 2013. Before making the maximum taxable gifts for the remainder of the 2012 year, clients need to be made aware of the possibility that maximizing their taxable gifts can cause a financial hardship if the gifts are made to grantor trusts. Before making such gifts, clients and their advisors need to take into account the financial impact caused by the grantor having to pay the income taxes on the grantor trust's taxable income and take precautionary steps if those projections show that the income tax treatment will not leave the grantor with sufficient assets for support in their later years.

For individuals with a life expectancy of over 20 years, making the maximum taxable gifts may not be the optimal strategy. In evaluating whether to take advantage of the \$5,120,000 gift tax exemption for the rest of the 2012 year, one needs to take into account the ages of the clients, their living expenses and the amount of their income-producing assets. The situation illustrated below shows that for a couple ages 62 and 59 with \$46,000,000 of investment assets, they should not make the maximum \$10,240,000 in taxable gifts to a grantor trust.

Although the primary objective of an outright gift in trust is to shift future income and future appreciation in value to the trust without any gift taxes, a separate wealth shifting benefit arises by the grantor's payment of the grantor trust's Federal and state income tax liabilities relating to the trust's taxable income (referred to as the "burn"). Over a long period of time, the transfer tax-free shifting of value from grantor trust status has a far greater impact than valuation discounts and the shifting of future income and future appreciation in value combined.

When there is a transfer to an irrevocable trust, and the trust is treated as a grantor trust for Federal income tax purposes, the Internal Revenue Code creates a fiction in that the individual who creates the trust (referred to as the "grantor") is deemed to own the trust's assets, and, as the deemed owner of the trust's assets, the grantor must report the trust's income on the grantor's individual income tax return even though the grantor does not receive a distribution of that income, such as when the income is accumulated or distributed to a trust beneficiary. Accordingly, the grantor must pay the income taxes on the trust's income at the grantor's individual income tax rates. The Internal Revenue

---

[16] Even if the estate tax exemption is continued at an amount up to \$5,000,000, there is a good possibility that the gift and estate tax exemptions will not be unified and that the gift tax exemption will be only \$1,000,000.

Service ruled that the grantor's payment of the income taxes on the grantor trust's income is not a gift for gift tax purposes.[17]

Suppose a grantor trust received a taxable gift of $5,000,000, with no gift taxes because the first $5,000,000 of taxable gifts is not subject to gift taxes, and the contributed asset generates $250,000 of ordinary income annually. If the combined state and Federal income tax on this income is $100,000 (a combined Federal and state effective income tax rate of 40%), the grantor is required to pay the income taxes on the trust's income. In effect, the grantor has effectively made a gift-tax free transfer of another $100,000. And, this indirect tax-free gift continues each year that the grantor is living and paying the income taxes on the grantor trust's income. Over a long period of time, the amount of wealth that can be shifted as the principal in the trust continues to grow can deplete far more wealth than was intended at the time the grantor trust was funded.

The following example illustrates the burn caused by the grantor's payment of the Federal and state income taxes on the trust's taxable income. The illustration demonstrates that for a couple ages 62 and 59 with $46,000,000 of investment assets, over a long period of time the burn can deplete far too much from their retained investment assets and leave the grantor with little or no assets if the grantor lives too long. Given their young age from an estate planning perspective, it may be advisable that this couple not make the maximum $10,000,000 of taxable gifts during the 2012 year.

> **Example** Mr. & Mrs. Senior are ages 62 and 59. Although their joint life expectancy under Table 2000CM is 26 years, there is a 50% probability that at least one of them will be living some 26 years from now. Given that they have access to better heath care, it is reasonable to expect that one of them will live to age 95. Therefore, any financial projection needs to illustrate the impact of the "burn" caused by grantor trust status for the next 36 years for an individual currently age 59. As residents of New York State, the impact of state income taxes needs to be taken into account. Their living expenses (other than Federal and state income taxes) need to be considered as those expenditures also deplete their estate. Their current living expenses are $600,000, and they will increase by 1% annually. Their investment assets are $$46,000,000 and generate a 5.25% rate of return (all ordinary income) over the 36-year period for the projections. They have been advised to take advantage of the maximum $5,120,000 taxable gifts that can be made before the end of the 2012 year without any gift taxes and decide to make two such gifts. But first, they contribute $13,333,333 of their investment assets to a family limited partnership. After applying a conservative 25% valuation discount, the value of their limited partnership interest is $10,000,000. They then give their discounted limited partnership interests to a grantor trust for the benefit of junior

---

17 Rev. Rul. 2004-64, 2004-2 C.B. 7.

family members. Assume that the grantor trust makes no distributions and reinvests the income each year at the same 5.25% investment rate of return.

The "burn" caused by grantor trust status over a long period of time can deplete such a significant amount in later years that by the time the 36 years expire, there is nothing left in their estate. The following example illustrates the impact of the "burn" caused by the trust receiving the maximum taxable gifts over a long period of time.

Retained Investment Assets After Gifts	$32,666,667
Pre-Discounted Value of Gifts	$ 13,333,333
Investment Assets Before Gifts	**$46,000,000**
Pre-discounted Value of Gift	($13,333,333)
Living Costs over 36 years	($25,846,127)
Seniors' Earnings over 36 years	$ 45,651,254
Income Taxes on Seniors' Earnings over 36 years	($21,126,117)
Income Taxes on Trust's Earnings over 36 years	($32,851,376)
Balance in Gross Estate at end of 36 years	($1,505,700)

Year	Age of younger spouse	Add: Earnings	Less: Tax on Earnings	Less: Tax on Trust Earnings	Less: Living Costs	Remaining investment assets after gifts made
						$ 32,666,667
2,012	60	1,715,000	717,728	292,950	600,000	32,770,990
2,013	61	1,720,477	799,162	342,220	606,000	32,744,085
2,014	62	1,719,064	798,505	360,187	612,060	32,692,397
2,015	63	1,716,351	797,245	379,097	618,181	32,614,225
2,016	64	1,712,247	795,339	398,999	624,362	32,507,772

Year	Age of younger spouse	Add: Earnings	Less: Tax on Earnings	Less: Tax on Trust Earnings	Less: Living Costs	Remaining investment assets after gifts made
2,017	65	1,706,658	792,743	419,947	630,606	32,371,134
2,018	66	1,699,485	789,411	441,994	636,912	32,202,302
2,019	67	1,690,621	785,293	465,199	643,281	31,999,150
2,020	68	1,679,955	780,339	489,622	649,714	31,759,430
2,021	69	1,667,370	774,493	515,327	656,211	31,480,769
2,022	70	1,652,740	767,698	542,381	662,773	31,160,657
2,023	71	1,635,934	759,892	570,856	669,401	30,796,442
2,024	- 72	1,616,813	751,010	600,826	676,095	30,385,324
2,025	- 73	1,595,230	740,984	632,370	682,856	29,924,344
2,026	- 74	1,571,028	729,743	665,569	689,685	29,410,376
2,027	- 75	1,544,045	717,209	700,512	696,581	28,840,119
2,028	- 76	1,514,106	703,302	737,288	703,547	28,210,087
2,029	- 77	1,481,030	687,938	775,996	710,583	27,516,599
2,030	- 78	1,444,621	671,027	816,736	717,688	26,755,770
2,031	- 79	1,404,678	652,473	859,615	724,865	25,923,495
2,032	- 80	1,360,983	632,177	904,744	732,114	25,015,443
2,033	- 81	1,313,311	610,033	952,243	739,435	24,027,043
2,034	- 82	1,261,420	585,929	1,002,236	746,830	22,953,467
2,035	- 83	1,205,057	559,749	1,054,854	754,298	21,789,624
2,036	- 84	1,143,955	531,367	1,110,233	761,841	20,530,138
2,037	- 85	1,077,832	500,653	1,168,521	769,459	19,169,338
2,038	- 86	1,006,390	467,468	1,229,868	777,154	17,701,238
2,039	- 87	929,315	431,667	1,294,436	784,925	16,119,525
2,040	- 88	846,275	393,095	1,362,394	792,775	14,417,537
2,041	- 89	756,921	351,590	1,433,920	800,702	12,588,246
2,042	- 90	660,883	306,980	1,509,200	808,709	10,624,239
2,043	- 91	557,773	259,085	1,588,433	816,796	8,517,696
2,044	- 92	447,179	207,715	1,671,826	824,964	6,260,370
2,045	- 93	328,669	152,667	1,759,597	833,214	3,843,562
2,046	- 94	201,787	93,730	1,851,976	841,546	1,258,097
2,047	- 95	66,050	30,680	1,949,204	849,962	(1,505,700)

As the assets in the grantor trust continue to grow, the taxable income earned by the grantor trust continues to increase, and the compounding of this growth results in a burn of over a million dollars a year starting when the couple reaches ages 84 and 81 (year 2034, which is some14 years before the younger spouse reaches age 95). Over the entire 36-year period the combined Federal and state income taxes paid by the grantor on the grantor trust's taxable income is $32,851,376. So, we have achieved the perfect estate plan! By the younger spouse's death at age 95, there is nothing left. Of course, the spouses then ask you "What happens if one of them is still alive in year 2047?"

Grantor Trust			
Year	Value of Gifts before discounts	Taxable Income	Balance
2,012	13,333,333	700,000	14,033,333
2,013	-	736,750	14,770,083
2,014	-	775,429	15,545,512
2,015	-	816,139	16,361,652
2,016	-	858,987	17,220,638
2,017	-	904,084	18,124,722
2,018	-	951,548	19,076,270
2,019	-	1,001,504	20,077,774
2,020	-	1,054,083	21,131,857
2,021	-	1,109,423	22,241,280
2,022	-	1,167,667	23,408,947
2,023	-	1,228,970	24,637,917
2,024	-	1,293,491	25,931,407
2,025	-	1,361,399	27,292,806
2,026	-	1,432,872	28,725,678
2,027	-	1,508,098	30,233,776
2,028	-	1,587,273	31,821,050
2,029	-	1,670,605	33,491,655
2,030	-	1,758,312	35,249,967
2,031	-	1,850,623	37,100,590
2,032	-	1,947,781	39,048,371
2,033	-	2,050,039	41,098,410
2,034	-	2,157,667	43,256,077
2,035	-	2,270,944	45,527,021

Grantor Trust			
Year	Value of Gifts before discounts	Taxable Income	Balance
2,036	-	2,390,169	47,917,190
2,037	-	2,515,652	50,432,842
2,038	-	2,647,724	53,080,566
2,039	-	2,786,730	55,867,296
2,040	-	2,933,033	58,800,329
2,041	-	3,087,017	61,887,346
2,042	-	3,249,086	65,136,432
2,043	-	3,419,663	68,556,095
2,044	-	3,599,195	72,155,290
2,045	-	3,788,153	75,943,442
2,046	-	3,987,031	79,930,473
2,047	-	4,196,350	84,126,823

As the above table illustrates, a $10,000,000 taxable gift to a grantor trust results in $84,126,823 accumulating in the trust free of all transfer taxes!

If a couple with $46,000,000 of investment assets is left with $32,666,667 of investment assets after making two $5 million taxable gifts, it initially appears that the income and principal from their remaining assets will be more than sufficient to provide the funds needed to pay their living expenses and the income taxes on the taxable income generated by their retained assets and the taxable income of the grantor trust. Initially, the income tax on the grantor trust's taxable income (the "burn") is $292,950, and the value of their retained investment assets actually increases for the next few years. As the assets in the grantor trust continue to grow, the burn gradually increases, and a point is reached in year 2033, when the younger spouse is age 81, where their retained assets ($24,027,043) generate taxable income ($1,313,311) that is sufficient to pay only the income taxes ($610,033) on the taxable income from their retained assets and their living expenses ($739,435). At this point, the annual burn has reached $952,243 and will continue to grow each year. Therefore, it may be practical to discontinue grantor trust status at the end of the 2033 year.

The above example assumed an investment rate of return of 5.25% so that the full depletion of their investment assets did not occur until the younger spouse reached age 95, some 36 years in the future. If the investment rate of return was 6.25%, their remaining funds would have exhausted in 32 years. And, at a 7.25% investment rate of return, their retained assets would have exhausted in 29 years.

As the above example illustrates, if this couple has more than $46,000,000 worth of investment assets, then making the maximum $10,000,000 in taxable gifts during 2012

will most likely leave them with sufficient income-producing assets if they survive well into their 90s. But, for couples at their age level with less than $46,000,000 of investment assets, maybe they should consider making taxable gifts in amounts less than the $10,000,000 maximum.

So, the next part of the analysis the estate planning profession must perform is to evaluate what can be done to stop the burn at the appropriate point in the future.

A simple solution is to draft the grantor trust agreement so that the power creating grantor trust status expires at a time in the future when the grantor no longer wants to continue to pay the income taxes on the grantor trust's taxable income. What is important is that the estate planning advisors address the impact of the burn at the time the gifts in trust are contemplated so that the clients are informed of the financial impact of their taxable gifts and can make a reasoned decision in advance as to how to deal with the burn.

Another solution is to use a non-grantor trust so that there is no burn from the inception.

A simple way to create a grantor trust is to provide that one of the discretionary beneficiaries is the grantor's spouse and that trust income *may be* (but is not required) distributed to the grantor's spouse.[18] In that manner, the grantor trust can make discretionary distributions to the grantor's spouse so that the distributed funds can be used to pay the income taxes caused by the burn.[19]

Discretionary tax reimbursement clauses have been addressed by the IRS in Rev. Rul. 2004-64[20] where the IRS stated that as long as there is no understanding, express or implied, that the independent trustee would exercise the discretion to reimburse the grantor for the income taxes that the grantor is obligated to pay on the grantor trust's income, that the trustee's discretion would not alone cause the inclusion of the trust in the

---

18 If the trust provides that it is for the benefit of the settlor's spouse in addition to the settlor's descendants, the trust is automatically treated as a grantor trust under § 677(a)(1). A trust for the benefit of a spouse will continue as a grantor trust only as long as the settlor's spouse is living.

19 Using a spousal limited access trust (a "SLAT") allows the trust to make distributions to the beneficiary spouse to pay the income taxes created by the burn as the spouses file joint income tax returns. But, as noted in Rev. Rul. 2004-64, 2004-2 C.B. 7, the IRS will view such distributions as an implied retention of a § 2036(a) retained right to enjoyment. Caution: If both spouses make taxable gifts to separate grantor trusts, the trusts must be drafted in a way to avoid the reciprocal trust doctrine. With two separate trusts, once one of the spouses dies, the trust created by the deceased grantor will no longer be a grantor trust, and that will eliminate the burn with respect to one of the trusts. But, if both spouses continue to live well into their 90s, the burn will continue to be a factor

20 If tax reimbursement distributions are mandatory, the IRS held that the grantor has retained a right to have the trust property expended in discharge of the grantor's legal obligation and that estate tax inclusion under § 2036(a)(1) is required.

grantor's gross estate for Federal estate tax purposes. The IRS then cautioned that such discretion, combined with other facts, may cause inclusion of the trust's assets in the grantor's gross estate. If such tax reimbursement distributions are never made, then there should not be any estate tax inclusion exposure. But, if discretionary tax distributions are eventually made because the grantor needs the financial support provided by such distributions, that may be sufficient to convince the trier-of-fact that other facts exist to find that there was an implied understanding that trust assets would be used for the benefit of the grantor. Since there are safer alternatives to deal with the burn, the author recommends that discretionary tax reimbursement clauses not be used.[21]

The trustee of the trust can wait and make decisions at a future point in time when the grantor feels that the burn needs to be eliminated or reduced. One alternative is to change the investment mix of the trust's assets to change the character of the grantor trust's income from ordinary income to tax tax-free income, long-term capital gains, or "qualified dividends" if that rate preference is still available. Another choice for investments is to invest in assets that have the potential for appreciation in value as there is no gain to report until the assets are sold. Lastly, the trustee of the grantor trust could use some of its cash to purchase a high cash value life insurance policy as the income earned by the cash value is tax-exempt and can be accessed income tax-free by borrowing form the cash value (policy loans are not income assuming the life insurance policy is not a MEC).[22]

The trustee of the trust can use its discretionary power to make distributions of the income-producing assets to the beneficiaries as a way of reducing the taxable income of the grantor trust. If distributions of income-producing assets are used to reduce the grantor trust's taxable income, the grantor may not want the distributions to be made directly to the individual beneficiaries as the tax, asset protection and other benefits of dynasty trusts are no longer available. So, the question that then arises is whether the grantor trust's distributions can be made into another trust that will not be a grantor trust? The resolution of whether trust distributions can be made to another trust is determined by the language in the trust agreement, including trustee powers and the use of trust protectors, and the impact of state law.

One final word of caution is appropriate. Several advisors suggest that all that is needed to end grantor trust status for the grantor trust is to "toggle off" grantor trust status. This toggling off can be accomplished by the grantor merely taking affirmative action by releasing the power in the trust that created grantor trust status or having the

---

[21] In several states, such as New York, discretionary tax reimbursement powers are read into the trustee's powers unless otherwise provided in the trust agreement. E.P.T.L. §7-1.11.

[22] Since the life insurance policy will be owned by a trust that is not included in the grantor's gross estate. Since the objective is to shelter the income earned by the cash value from income taxation, the insured need not be on the life of the grantor, but can be on the life a beneficiary. When high cash value life insurance policies are needed, and there will be large premium payments, the trustee should consider the use of private placement life insurance ("PPLI") products.

trustee or trust protector cancel that power. Given that the grantor's debt obligation is cancelled by toggling off grantor trust status, the logical question to then ask is whether this cancellation gives rise to discharge of indebtedness income for Federal income tax purposes?

The narrow situation when an existing trust liability to an unrelated person is attributable to the grantor because of grantor trust status and that liability is deemed shifted to the trust when grantor trust status is terminated while the grantor is still alive is the only guidance we have as to the income tax consequences when grantor trust status is terminated.[23] These authorities treated the liability shift as an income tax realization event, specifically as an income tax sale under Section 1001(a). These authorities all involved a liability owed to a third party and did not address a liability of the grantor. Because these authorities take the position that the shifting of the third-party liability from the grantor to the non-grantor trust is an income tax realization event, that leads to the question whether the grantor would incur discharge of indebtedness income under § 61(a)(12) when the grantor's obligation to pay the income taxes on the trust's income is shifted to the trust upon termination of grantor trust status. This issue has never been addressed by the IRS in its Regulations, in any of its official and unofficial administrative pronouncements or in the case law, and its resolution remains unclear at this time.

The IRS takes the position that the grantor does not make a gift when the grantor pays the income taxes on the trust's income because that liability is the grantor's liability, and the IRS concludes that one cannot make a gift by paying one's own liability.[24] Because the IRS's position in Revenue Ruling 2004-64 recognizes the existence of this liability, although limited to the transfer tax consequences, it could lead one to the conclusion that when the grantor's liability is shifted to the trust, the grantor's liability is cancelled. Therefore, for income tax purposes, the grantor has to recognize discharge of indebtedness income under § 61(a)(12) of the Code.[25]

A contrasting view is that discharge of indebtedness income should not result upon the cancellation of the grantor's obligation to pay the income taxes on the trust's taxable income. The reason for attributing items of income, deduction, and credit to the grantor under § 671 is that the grantor is deemed to be the owner of the trust property. The IRS's position of treating the grantor as the owner of the trust's assets is, therefore, consistent with and supported by the rationale in Rev. Rul. 85-13[26]. In other words, tax

---

[23] Treas. Reg. § 1.1001-2(c) Example 5; Rev. Rul. 77-402, 1977-2 C.B. 222 and *Madorin v. Commissioner*, 84 T.C. 667 (1985).

[24] Rev. Rul. 2004-64, 2004-2 C.B. 7.

[25] The IRS's statement in C.C.A. 2009-23-024 (Dec. 31, 2008) that conversion of a non-grantor trust to a grantor trust is not a transfer for income tax purposes of the property held by the non-grantor trust to the owner of the grantor trust that requires the recognition of gain to the owner is questionable.

[26] 1985-1 C.B. 184.

liability attaches to the owner of the property. As the deemed owner of the property, the grantor's payment of income tax is in discharge of his own obligation. The income tax cannot be an obligation owed to the trust, because the trust does not exist for Federal income tax purposes. The language of Rev. Rul. 2004-64[27] supports this by stating that "any income tax [the grantor] pays that is attributable to Trust's income is paid in discharge of [the grantor's] own liability, imposed on [the grantor] by § 671."

It is only after grantor trust status terminates that the non-grantor trust springs into life as a separate entity for Federal income tax purposes. The grantor is deemed to relinquish ownership of the trust assets at that time. The trust, as owner of the assets must pay the resulting income tax liability. This transfer appears analogous to an individual who transfers income producing property by gift. While the individual owns the property, he reports the income from it, and thus pays the income tax on the income produced. Once the individual transfers the property to another person, he no longer reports its income, and thus has no corresponding obligation to pay the income taxes associated with the property. He does not, however, recognize any discharge of indebtedness income on the actual transfer of an income-producing asset by gift. Likewise, one should be treated similarly if there is a deemed transfer of an income-producing asset when grantor trust status is terminated.

Given the uncertainty of the income tax consequences when grantor trust status is toggled off, it is best not to rely upon the toggling off alternative and use any of the alternatives suggested above. The most practical of the alternatives is to perform a financial projection, decide at the time the grantor trust agreement is drafted when grantor trust status should end and have the power that creates grantor trust status automatically expire by the trust terms.

As the above illustrations point out, before advising a client to make the maximum tax gifts using the existing $5,120,000 exemptions available for the remainder of the 2012 year, a financial analysis needs to be undertaken, taking into account the ages of the donors, the amount of their investment assets, the character of the income generated by the investment assets owned by the grantor trust, their living and consumption expenses, the state income tax rates for their state of residence and any other factors that may impact on their financial status. Only after this analysis is performed, can the clients, with the guidance of their estate planning advisors, decide upon the level of taxable gifts to make before the end of the 2012 year.

---

27 2004-2 C.B. 7.

VI. Use of testamentary CLATs to pass controlling interests in both public and private companies without estate taxes.

Individuals with levels of wealth far in excess of the estate tax exemptions do not need, nor do they depend upon, the income or principal from their controlling ownership interests in companies. These individuals are frequently reluctant to dispose of these controlling interests using available estate planning techniques while they are alive for any one of a number of reasons, especially if the controlling interest is in a public company. The most significant drawback of retaining ownership of a controlling interest in a company is that the value of the controlling interest will be exposed to the estate tax, with the financial consequences that the individual's estate will have to sell a significant portion of the controlling interest to pay the estate taxes. The resultant sale of a portion of the controlling interest may mean that the individual's descendants (typically a trust for junior family members) may not have sufficient shares to maintain the desired control. This is especially a concern for small cap public companies where there are two classes of common stock, where the Class A shares have 9 votes for each share and the Class B shares have 1 vote for each share. The super voting shares need only represent a small portion of the total equity in the public company. It is typical that the controlling shareholder is the founder of the company and would like to see that control pass on to their descendants, typically in a dynasty trust that is GST tax exempt so as to maintain the family control indefinitely.

The zeroed out CLAT is a way to pass on assets without any gift taxes. To further expand on this zeroed out ability, one should consider the testamentary zeroed out charitable lead annuity trust (the "TCLAT"). Since there is no limit on the duration of charitable lead annuity trusts, it can be for any fixed term no matter how long. The number of years for the trust term should be for the number of years needed to zero out the remainder interest using as the annuity the dividend income the shares generate. In other words, the TCLAT term will be for the number of years, using the Section 7520 rate at the date of death, where the present value of the dividend income from the shares will equal the value of the shares placed in the TCLAT. Since the primary concern is to maintain voting control, it really does not matter that the TCLAT has a long term, even 50 or more years, especially since there is no financial need for the dividend income generated by the shares in trust.[28]

---

28 A comprehensive discussion of this technique, and the special self-dealing traps under the private foundation rules, was presented by Diana Zeydel, "*Cutting Edge Estate Planning Techniques: The 99-Year GRAT, Leveraged GRATs, Using Testamentary CLATs to Avoid the Sale of Assets to Pay Estate Taxes and Supercharging Installment Sales to Grantor Trusts"* at the 38th Annual Notre Dame Tax & Estate Planning Institute, Chapter 18 (September 20 and 21, 2012)

VII. Interest-only installment sale to grantor trust

Assume that the Seniors have a total of $32,000,000 invested in high grade corporate bonds paying 5.35% annually. Because their Federal and state income taxes and their living expenses do not exceed the income produced by their investment portfolio, without an estate plan, their taxable estate increases every year. The following illustration also is intended to highlight that large life insurance premiums can be paid by the trust without having to resort to annual exclusion gifts and thus eliminate the need to draft Crummey powers into the trust agreement. Let the clients use their annual exclusion gifts for other purposes!

Client Name	Mr. & Mrs. Senior		
Value of asset to FLP	20,000,000		
Applicable discount	25.00%		
Value of limited partnership interest	15,000,000		
Note Principal	15,000,000		
Basis in assets	20,000,000		
Terms of Note:			
Note Interest Rate	3.50%		
Interest Only Balloon At The End Of Note Term	20	Life expectancy	
Seller's Age	68	17.6 years	
Spouse's Age	62	22.5 years	
Joint Life Expectancy		25.5 years	
Extend BEYOND life expectancy?		Yes	
Number of years beyond life expectancy		5 years	
Term of Projection (rounded up)		31 years	
Estimated Annual Living Expenses		$300,000	
Estimated Annual Living Expenses Inflation Rate		1%	

California	State Of Residence	
Assumptions:		GST rate
Estate Tax Rate	45.00%	69.75%
Value of the Seniors' other assets		9,333,334
Gift In Trust before discount		2,666,666
Discounted Value of Gift/Taxable gift		2,000,000
Pretax Investment Earnings Rate		5.35%
Percent of Earnings Taxed as Ordinary Income		100.00%
Unused Unified Credit ($3,500,000 exemption)		5,000,000

Senior with no tax planning

Year	Ordinary Income (5.35%)	**Less:** Income taxes on Ordinary Income	Net cash after income taxes	**Less:** Living expenses	**Less:** Life insurance premiums	Ending Principal $32,000,000
1	1,712,000	758,416	953,584	300,000	100,000	32,553,584
2	1,741,617	771,536	970,081	303,000	100,000	33,120,665
3	1,771,956	866,486	905,469	306,030	100,000	33,620,104
4	1,798,676	879,552	919,123	309,090	100,000	34,130,137
5	1,825,962	892,896	933,067	312,181	100,000	34,651,022
6	1,853,830	906,523	947,307	315,303	100,000	35,183,026
7	1,882,292	920,441	961,851	318,456	100,000	35,726,421
8	1,911,364	934,657	976,707	321,641	100,000	36,281,487
9	1,941,060	949,178	991,881	324,857	100,000	36,848,512
10	1,971,395	964,012	1,007,383	328,106	100,000	37,427,789
11	2,002,387	979,167	1,023,220	331,387	100,000	38,019,622
12	2,034,050	994,650	1,039,399	334,701	100,000	38,624,321
13	2,066,401	1,010,470	1,055,931	338,048	100,000	39,242,205
14	2,099,458	1,026,635	1,072,823	341,428	100,000	39,873,600
15	2,133,238	1,043,153	1,090,084	344,842	100,000	40,518,842
16	2,167,758	1,060,034	1,107,724	348,291	100,000	41,178,276
17	2,203,038	1,077,285	1,125,752	351,774	100,000	41,852,254
18	2,239,096	1,094,918	1,144,178	355,291	100,000	42,541,141
19	2,275,951	1,112,940	1,163,011	358,844	100,000	43,245,308
20	2,313,624	1,131,362	1,182,262	362,433	100,000	43,965,137
21	2,352,135	1,150,194	1,201,941	366,057	100,000	44,701,021
22	2,391,505	1,169,446	1,222,059	369,718	100,000	45,453,362
23	2,431,755	1,189,128	1,242,627	373,415	100,000	46,222,574
24	2,472,908	1,209,252	1,263,656	377,149	100,000	47,009,081
25	2,514,986	1,229,828	1,285,158	380,920	100,000	47,813,318
26	2,558,013	1,250,868	1,307,144	384,730	100,000	48,635,733
27	2,602,012	1,272,384	1,329,628	388,577	100,000	49,476,784
28	2,647,008	1,294,387	1,352,621	392,463	100,000	50,336,943
29	2,693,026	1,316,890	1,376,137	396,387	100,000	51,216,692
30	2,740,093	1,339,905	1,400,188	400,351	100,000	52,116,528
31	2,788,234		1,363,447	404,355	100,000	**53,036,961**

Because the annual build-up in their assets was in their estate, their entire $53,036,961 (and the $4,000,000 of life insurance they purchased) is exposed to the estate tax and the GST tax.

	Senior With No Tax Plan	Senior With Tax Plan	Trust With Tax Plan
Beginning Principal	32,000,000	none	22,666,666
Other Assets		9,333,334	-
Note Principal		15,000,000	(15,000,000)
Interest Paid By The Trust on note		10,500,000	(10,500,000)
Income Earned	68,136,824	14,271,756	53,865,068
Income Taxes paid by Senior	(33,160,040)	(33,160,040)	-
Living Expenses	(10,839,822)	(10,839,822)	
Life Insurance Premiums	(3,100,000)		(3,100,000)
Life Insurance Death Benefit	4,000,000		4,000,000
Total assets at death	57,036,961	**5,105,227**	51,931,734
Transfer Taxes After Unified Credit	(23,416,633)	(47,352)	
Net After Transfer Taxes	33,620,329	5,057,875	51,931,734
Combined assets after death		56,989,609	
Tax Benefit of plan		**$23,369,280**	

Mr. and Mrs. Senior contribute $22,666,666 worth of assets to their family limited partnership in exchange for a limited partnership interest, and apply a conservative 25% valuation discount in valuing their limited partnership interest. They make a $2,000,000 taxable gift of a limited partnership to the grantor trust. They then sell a $15,000,000 limited partnership interest to the grantor trust, taking back the trust's $15,000,000 interest only installment note with a 20 year term and paying 3.50% annual interest. They have retained $9,333,334 of income-producing assets. By the time Mrs. Senior reaches age 95 only $105,227 is exposed to the estate tax. Consider the following financial projection for the Seniors with the tax plan in place. The retained $9,333,334 of income-producing assets is slowly depleted during the 20-year note term as the interest received on the grantor trust's promissory note is not sufficient to fund the payment of the grantor trust's income taxes, their income taxes and their living expenses. By the time the note matures, the assets retained by the Seniors have been depleted to $2,000,000. If grantor trust status continues, then during this 11-year period after the note is paid, their assets are further depleted. During the 31 years, the Seniors paid a total of $33,160,040 of income taxes of which $26,227,007 was the income taxes on the grantor trust's taxable income. And, the income taxes paid by the Seniors on the grantor trust's income for the 11 years after the note matured in year 20 was $10,366,201. One must be sensitive to the further depletion of the grantor's assets after the note principal is paid and decide whether or not to continue grantor trust status after the note principal is fully satisfied.

Year	Principal Payment Received	Interest paid by Trust	Income on retained assets	<u>Less</u>: tax on Income	<u>Less</u>: Tax on Trust's Income	Seniors' Annual Net Cash	<u>Less</u>: Living Expenses	Ending Principal $9,333,334
1		525,000	499,333	221,205	537,211	265,917	300,000	9,299,251
2		525,000	497,510	220,397	551,139	250,974	303,000	9,247,225
3		525,000	494,727	241,921	624,565	153,240	306,030	9,094,435
4		525,000	486,552	237,924	641,628	132,000	309,090	8,917,345
5		525,000	477,078	233,291	659,604	109,182	312,181	8,714,346
6		525,000	466,218	227,980	678,542	84,695	315,303	8,483,738
7		525,000	453,880	221,947	698,493	58,439	318,456	8,223,721
8		525,000	439,969	215,145	719,512	30,312	321,641	7,932,393
9		525,000	424,383	207,523	741,655	205	324,857	7,607,741
10		525,000	407,014	199,030	764,982	(31,998)	328,106	7,247,637
11		525,000	387,749	189,609	789,558	(66,419)	331,387	6,849,832
12		525,000	366,466	179,202	815,448	(103,184)	334,701	6,411,947
13		525,000	343,039	167,746	842,724	(142,431)	338,048	5,931,468
14		525,000	317,334	155,176	871,459	(184,301)	341,428	5,405,739
			289,207		901,731			

15	525,000		141,422		(228,946)	344,842	4,831,951
16	525,000	258,509	126,411	933,623	(276,524)	348,291	4,207,136
17	525,000	225,082	110,065	967,220	(327,204)	351,774	3,528,158
18	525,000	188,756	92,302	1,002,616	(381,161)	355,291	2,791,706
19	525,000	149,356	73,035	1,039,905	(438,584)	358,844	1,994,278
20	525,000	106,694	52,173	1,079,189	14,500,332	362,433	16,132,177
21	-	863,071	422,042	728,152	(287,122)	366,057	15,478,997
22	-	828,126	404,954	764,492	(341,319)	369,718	14,767,960
23	-	790,086	386,352	802,776	(399,042)	373,415	13,995,503
24	-	748,759	366,143	843,109	(460,492)	377,149	13,157,862
25	-	703,946	344,229	885,599	(525,882)	380,920	12,251,059
26	-	655,432	320,506	930,362	(595,436)	384,730	11,270,893
27	-	602,993	294,863	977,520	(669,391)	388,577	10,212,925
28	-	546,391	267,185	1,027,201	(747,995)	392,463	9,072,467
29	-	485,377	237,349	1,079,541	(831,513)	396,387	7,844,567
30	-	419,684	205,226	1,134,680	(920,221)	400,351	6,523,995
31	-	349,034	170,677	1,192,769	(1,014,413)	404,355	5,105,227

The $5,105,227 remaining in the taxable estate has been reduced so that the impact of the estate tax is almost non-existent due to the $5,000,000 of exemption remaining under their combined unified credits. The estate plan is almost perfect as only $105,227 remains exposed to estate taxes.

Grantor Trust with tax plan

Year	Note Payment	Ordinary Income (5.35%)	Less: Annual Interest	Annual net Increase In Funds	Less: life Insurance Premiums	Ending Principal
						$22,666,666
1		1,212,667	525,000	687,667	100,000	23,254,333
2		1,244,107	525,000	719,107	100,000	23,873,439
3		1,277,229	525,000	752,229	100,000	24,525,668
4		1,312,123	525,000	787,123	100,000	25,212,792
5		1,348,884	525,000	823,884	100,000	25,936,676
6		1,387,612	525,000	862,612	100,000	26,699,288
7		1,428,412	525,000	903,412	100,000	27,502,700

8		1,471,394	525,000	946,394	100,000	28,349,095
9		1,516,677	525,000	991,677	100,000	29,240,771
10		1,564,381	525,000	1,039,381	100,000	30,180,152
11		1,614,638	525,000	1,089,638	100,000	31,169,791
12		1,667,584	525,000	1,142,584	100,000	32,212,374
13		1,723,362	525,000	1,198,362	100,000	33,310,736
14		1,782,124	525,000	1,257,124	100,000	34,467,861
15		1,844,031	525,000	1,319,031	100,000	35,686,891
16		1,909,249	525,000	1,384,249	100,000	36,971,140
17		1,977,956	525,000	1,452,956	100,000	38,324,096
18		2,050,339	525,000	1,525,339	100,000	39,749,435
19		2,126,595	525,000	1,601,595	100,000	41,251,030
20	15,000,000	2,206,930	525,000	(13,318,070)	100,000	27,832,960
21		1,489,063		1,489,063	100,000	29,222,023
22		1,563,378		1,563,378	100,000	30,685,402
23		1,641,669		1,641,669	100,000	32,227,071
24		1,724,148		1,724,148	100,000	33,851,219
25		1,811,040		1,811,040	100,000	35,562,259
26		1,902,581		1,902,581	100,000	37,364,840
27		1,999,019		1,999,019	100,000	39,263,859
28		2,100,616		2,100,616	100,000	41,264,475
29		2,207,649		2,207,649	100,000	43,372,125
30		2,320,409		2,320,409	100,000	45,592,534
31		2,439,201		2,439,201	100,000	47,931,734

Since the trust is able to generate sufficient excess funds each year, it can easily pay the $100,000 annual life insurance premium out of its own funds without the grantor having to resort to any annual exclusion gifts (Crummey powers) or even any taxable gifts. In addition to the $47,931,734 accumulated in the grantor trust, the grantor trust also collects the $4,000,000 death benefit from the life insurance policy. The death benefit can provide the funds needed to pay any estate taxes if the surviving spouse does not survive to age 95. If the surviving spouse dies at age 89 (year 26), the taxable estate has been depleted to $11,270,893, and at a 45% estate tax rate on the taxable estate in excess of $5,000,000, the life insurance death benefit can provide the funds needed to pay the estate taxes on this $6,270,893 taxable amount. If the surviving spouse dies sooner,

say in year 23, the taxable estate will be $13,995,503 and the estate tax will be $4,047,976. The $4,000,000 death benefit can eliminate any liquidity problems.

Although the size of the discount in the long run is the least significant wealth depletion factor, the absolute amount of the future tax savings from a large discount over a more conservative discount can be substantial. However, when one takes into account the present value of the tax savings attributable to a lower valuation discount, and also takes into consideration that the present audit exposure of the gift tax return is reduced, one may conclude that foregoing the additional potential tax savings from a larger discount is worthwhile and can be considered a cost for minimizing audit exposure. Remember that the estate tax savings will not occur until far in the future upon the death of the surviving spouse while the exposure to a gift tax audit occurs today. The following table illustrates the absolute tax savings and the present value of the absolute tax savings starting with a conservative valuation discount of 25% and comparing the additional tax savings from 30%, 35% and 40% valuation discounts. The comparison starts with a couple ages 68 and 63, living in New York City, a 20-year interest-only promissory note with annual interest at 4.11% (the January 2010 long-term AFR),[29] with $42,000,000 of corporate bonds yielding 5½%, a 30-year projection and continuing grantor trust treatment after the note is paid at maturity. The couple retains $19,333,334 worth of corporate bonds and transfers $22,666,666 worth of corporate bonds to a family limited partnership in exchange for a limited partnership interest. The couple gifts a limited partnership interest with a $2,666,666 capital account to the grantor trust as seed money and sells a limited partnership interest with a $20,000,000 capital account to the grantor trust, both the gift and the sale use the discounted value of the limited partnership interests. The following table compares the tax results for an installment sale to a grantor trust using different valuation discount assumptions.

Discount %	**Estate tax paid upon death of surviving spouse**	**Taxable estate upon death of surviving spouse**	**Tax savings over the 25% valuation discount**	**Present value of estate tax savings[30]**
25%	$8,660,625	$24,245,834	-------	-------
30%	$6,714,314	$20,054,033	$1,946,311	$ 571,389
35%	$4,768,004	$15,862,231	$3,892,621	$1,142,779
40%	$2,821,693	$11,670,429	$6,838,932	$2,007,744

29 Rev. Rul. 2010-1, 2010-2 I.R.B. (Dec. 22, 2009).

30 The annual 4.11% long-term AFR for January 2010 was used as the discount rate, and the present value was for a period 30 years in the future.

VIII. Communication

Communicating how a technique works and communicating the wealth shifting concepts incorporated in that technique is an important goal for an estate planning professional. Part of the communication process is to explain the technique is a way that the individual can easily understand; without the use of technical terms that the individual is often unfamiliar. An important aspect of the communication process is to illustrate the potential transfer tax savings without overwhelming the individual with complicated and often voluminous financial data. The following explanation uses a charitable remainder annuity trust (a "CLAT") to illustrate how to accomplish the communication objective in a brief amount of time without the use of technical terms.

Assume an individual, a resident a state without an income tax on individuals, with little of no charitable intentions, owns a $1,000,000 portfolio of bonds, paying $50,870 of annual interest (a 5.087% return). The individual transfers these bonds to a CLAT with a 22-year fixed term. Assume the gift tax rate is 45% and that the Section 7520 rate is 1.0%.[31]

We know that a CLAT works the same way as a GRAT except the annuity is given to charity instead of retained by the trust creator. Since there is no retained annuity interest, and if the remainder is gifted away at formation, there is no exposure to estate tax inclusion if the creator of the CLAT dies during the CLAT term as there is with a GRAT. It is the use of financial leverage (the assumption that the investment rate of return is greater than the Section 7520 rate) and the compounding of that leverage over a long period that produces the favorable results. The lifetime CLAT for someone with a short remaining life expectancy is an ideal vehicle to take advantage of the compounding over a long period of time. Below are four alternative gift scenarios using the above $1,000,000 income-producing asset and the net results under each.

<u>ALTERNATIVE No. 1</u>

Senior retains the $1,000,000 investment portfolio, earning 5.087% annually, pays the income taxes on the earnings each year and allows all earnings, after the payment of income taxes, to accumulate. At the end of 22 years, the investment fund has grown to $1,959,299. Senior gifts the entire $1,959,299 of accumulated funds directly to her children. After the payment of the $881,685 in gift taxes, computed at a 45% gift tax rate, on this taxable gift, the children effectively net $1,077,615.

---

31 Charitable lead trusts can use the Section 7520 rate for the month the trust is established and use that rate for the two succeeding months. Since the Section 7520 rate for November 2012 is 1.0%, the November 2012 rate can also be used for trusts created during December 2012 and January 2013 especially since the Section 7520 rate increased after November 2012. The Section 7520 rate for December 2012 is 1.2%.

ALTERNATIVE No. 2

Each year Senior gifts the entire $50,870 of annual investment income to charity and gifts the $1,000,000 investment portfolio to the children at the end of 22 years. The children effectively net $550,000 after the payment of gift taxes at the 45% rate, and the charity receives $1,119,140 over the 22-year period.

ALTERNATIVE No. 3

Senior contributes the $1,000,000 investment portfolio to a CLAT which in turn is required to distribute a fixed annuity of $50,870 to charity over a 22-year period, which is the same $50,870 of annual income. Since the value of the remainder interest to Senior's children is zero, there is no gift at the time the trust was created. At the end of 22 years, the CLAT terminates and distributes all $1,000,000 to the children without incurring any gift taxes. Therefore, the children net $1,000,000, and the charity receives the same $1,119,140 over the 22-year period.

ALTERNATIVE No. 4

Senior uses a family limited partnership ("FLP"), contributing the $1,000,000 investment portfolio to a family limited partnership. After taking a conservative 25% valuation discount, Senior contributes the discounted limited partnership interest to a CLAT, which is required to pay $38,148 annually to charity over the 22-year CLAT term. Over the 22-year period, the charity receives $839,256. And, upon termination of the CLAT, it distributes $1,239,914 to the children, free of all gift taxes.

Alternative	**Net to Children**	**Charitable Contributions**	**Total to Intended Beneficiary(ies)**
Alternative No. 1 No tax planning No charitable contribution	$1,077,615	None	$1,077,615
Alternative No. 2 No tax planning $57,673 annual charitable contribution	$ 550,000	$1,119,140	$1,669,140
Alternative No. 3 CLAT makes $57,673 of annual charitable contributions	$ 1,000,000	$1,119,140	$2,119,140

Alternative	Net to Children	Charitable Contributions	Total to Intended Beneficiary(ies)
Alternative No. 4 Use of a discounted FLP, CLAT makes $43,255 of annual charitable contributions	$1,239,914	$839,256	$2,079,170

By having the CLAT make the annual charitable contributions under Alternative No. 3, an individual can pass on more to her children than doing no tax planning and still give over $1,000,000 to charity.[32] For an individual who is already making significant charitable contributions in their individual capacity, using the CLAT for the same charitable giving allows that individual to take advantage of the potential gift and estate tax savings.

By comparing Alternative #1 to Alternative #3, the total of $1,119,140 in annual distributions to charity only cost the individual $77,615.[33] The individual is giving to charity the equivalent of the gift taxes one would have otherwise paid if the charitable lead trust had not been used.

By using a family limited partnership illustrated in Alternative #4, the transfer tax savings show that the individual's children are significantly better off.

One must be aware that the use of the CLAT produces this favorable result only because of the historically low 1.0% Section 7520 rate. At a 2.0% Section 7520 rate the annual annuity needed to zero out the CLAT over 22 years would be $56,632, and if the investment rate of return was still 5.087%, the amount remaining in the trust at the end of 22 years would be only $891,349 under Alternative #3.

---

32 This illustration assumes that the individual desires to give to charity. If the individual has no charitable desires, then the individual may have been able transfer more on to the children using another estate planning technique such as a GRAT.

33 In a state with a state income tax, the individual would be slightly better off.

IX. Contribution of appreciated art to a public charity that is not a museum and still take a charitable deduction for the full value of the art.

Senior purchased a valuable painting in 1947 for $450,000, and it is now valued at $10,000,000. Senior wants to contribute the painting to a public charity, such as the Casto Pain Center at Mt. Sinai Hospital.

Under Section 170(e)(1)(B)(i), for the contribution of tangible personal property to a charity where the charity's use of the contributed asset is not related to the function for its tax-exempt status, the income tax charitable deduction is limited to the donor's cost basis.

If Senior contributes the painting to a charity that is not a museum, his income tax deduction will be limited to his $450,000 cost. True, the charity will net $10,000,000 on the sale of the painting, but Senior wants a larger charitable income tax deduction.

Senior's accountant tells Senior to sell the painting for $10,000,000 in cash, pay the 28% capital gains tax on collectibles and contribute the $7,200,000 after tax sale proceeds to charity. But, Senior wants the entire $10,000,000 deduction and wants the charity to receive $10,000,000, not $7,200,000.

When no one is able to come up with an idea to accomplish what Senior desires, Senior calls you who recommends the use of a charitable remainder annuity trust (the "CRAT") with a one-year term. Alternatively, the term for the CRAT can be longer (up to 20 years if a fixed term is used) with a later contribution of the retained annuity interest to the charity after waiting a sufficient period of time so that exposure to the step transaction doctrine is minimized.

> **Example.** Senior contributes the painting to a CRAT with a one-year term when the Section 7520 rate is 1.2%. The remainder beneficiary of the CRAT is a public charity. Senior retains a fixed annuity of $508,700. Thus, the value of the remainder interest is $9,491,300, which is the charitable income tax deduction Senior is able to take for the year the CRAT is funded.[34] Senior can keep the annuity or contribute the cash received from the annuity to a charity. If a ten-year CRAT is used, the value of the remainder interest is $5,233,230. Senior can contribute the annual annuity each year. Or, Senior can sell the retained annuity interest to the charity and then gift the note to the charity.

---

[34] Unlike a grantor CLT where the charitable income tax deduction can offset up to 30% of adjusted gross income, the AGI limit is 50% of AGI for a CRT.

X. Planning for the remainder of the 2012 year.

A. Benefits of 2012 Gifts

1. Exemptions are the highest they have ever been.

2. The values of many assets remain depressed, especially commercial real estate

3. The Applicable Federal Rate and the Section 7520 rate are still at their historical lows. The December 2012 Section 7520 rate is 1.2%. The ability to lock in this extremely low hurdle rate for a long period of time as eventually interest rates will increase over the long run.

4. With the possibility that the exemptions will revert to $1,000,000 in 2013, or $3,500,000 under the Obama Administration proposal, there may never be another opportunity to give away as much without any gift taxes.

5. Even if exemptions are lower in 2013, making maximum gifts in 2012 shifts all appreciation and all income from the gifted property to grow in the hands of a family trust that is not exposed to the transfer taxes.

6. The wealth shifting can be even greater if the donee is a grantor trust where the grantor pays the income taxes on the grantor trust's taxable income.

7. The concern that there may be a "clawback" only affects the amount of the taxable gift. All of the other wealth shifting advantages of a gift (shift future appreciation and future income and payment of the income taxes on the trust's income) are not affected.

8. Generation skipping transfer tax exemption has same impact as the gift tax exemption, especially if the trust is a dynasty trust.

9. Possible risk that Obama legislative proposals will be adopted. If adopted, changes will be prospective only. Therefore, why take the risk of elimination of several wealth shifting techniques when the implementation of a technique before year-end will be grandfathered.

B. Some ideas to consider.

1. **Gift leasebacks**. For gifts of real property to a grantor trust, such as a vacation home, the donor should consider leasing the transferred property back as the rentals will further deplete one's assets.

2. **"Generation-Jumping" gifts**. Consider skipping the grandchildren and have the trust for the great grandchildren. If a donor has used the entire GST exemption, the donor can create a trust for the great grandchildren and pay only one GST tax.

3. **High interest rate notes.** Cancellation of prior installment notes that were given in the past when the AFR was much higher than the 2.40% long-term AFR in effect for December 2012.

4. **Enhancement of the use of QPRTs**. In prior years, the value of the remainder interest for multi million dollar residences created taxable gifts far in excess of the $1,000,000 gift tax exemption. With a $5,120,000 gift tax exemption, the entire remainder interest can be sheltered from the payment of the gift tax.

5. **Early termination of existing QTIP trusts**. Consider freezing the assets in the QTIP trust at their current values.

6. **Self-Settled asset protection trusts.** Consider the goals we discussed at the beginning of this paper. In all but a handful of states, if the creator of the trust gives an independent trustee the discretion to make distributions to the creator, the trust's assets will be included in the creator's gross estate even though the creator has no ability to compel the independent trustee to make discretionary distributions to the creator. However, there are a few jurisdictions where giving the independent trustee the discretion to make distributions to the person who created the trust. The four most popular jurisdictions for these trusts (referred to as "self-settled trusts") are Alaska, Delaware, Nevada, and South Dakota. Although such trusts created in all four states will not expose these self-settled trusts to estate tax, it turns out that each state does not offer the same level of asset protection as they are different waiting periods and in all but Nevada there are exempted creditors for alimony and child support.

7. **Spousal Limited Access Trusts ("SLAT").** The creator of the trust can name a spouse and descendants as discretionary beneficiaries of the trust. And, the spouse can be given a special power of appointment. If a spouse is a discretionary beneficiary only, then the trust's assets cannot be included in the spouse's estate at death. One would be wise to define the term spouse as "the person I am currently married to at the time" and avoid using the actual name of the current spouse. Thus, the creator can indirectly be able to receive the economic benefit of the trust if the independent trustee makes discretionary distributions to the spouse. One drawback is that if there is no longer a spouse, because of a death or divorce, this indirect benefit is no longer available. Another problem is

that a trust where a spouse is a discretionary beneficiary may not be eligible for the split gift election. Another concern is the potential application of the reciprocal trust doctrine if each spouse creates a SLAT.

As pointed out, the SLAT has some drawbacks. There can be several advantages of the self-settled trust over the SLAT.

a. Nevada has no exemption creditors, such as alimony.

b. P.L.R. 2009-44-002 held that the Alaska self-settled trust will not be exposed to the estate tax as long as the subsequent facts show that there was no implied understanding that the independent trustee will exercise its discretion in favor of the creator of the trust.

c. Overcome drawbacks created because trusts that are not in the estate are irrevocable and cannot arbitrarily changed.

d. Decanting has its limitations and is not available in all states.

e. Ability for the creator to receive discretionary distributions can give the creator a sense of security in the event the creator has financial reverses in the future or if the payment of the income taxes on the grantor trust's income is too great a financial burden on the creator/grantor.

f. Allows for the creator to take other steps to further reduce estate tax exposure by disposing of other assets as the creator has the security of knowing that there is a financial backup.

8. The 99-year GRAT with Section 7520 rates at historical lows.

9. Leveraged and front-loaded GRATs.

Individuals with levels of wealth far in excess of the estate tax exemptions that do not need, nor do they depend upon, the income or principal from their controlling ownership interests in companies. These individuals are frequently reluctant to dispose of these controlling interests using available estate planning techniques while they are alive for any one of a number of reasons, especially if the controlling interest is in a public company. The most significant drawback of retaining ownership of a controlling interest in a company is that the value of the controlling interest will be exposed to the estate tax, with the financial consequences that the individual's estate will have to sell a significant portion of the controlling interest to pay the estate taxes. The resultant sale of a portion of the controlling interest may mean that the individual's descendants (typically a

trust for junior family members) may not have sufficient shares or other interests to maintain the desired control. This is especially a concern for small cap public companies where there are two classes of common stock, where the Class A shares have 9 votes for each share and the Class B shares have 1 vote for each share. The super voting shares need only represent a small portion of the total equity in the public company. It is typical that the controlling shareholder is the founder of the company and would like to see that control pass on to their descendants, typically in a dynasty trust that is GST tax exempt so as to maintain the family control indefinitely.

As was discussed earlier this afternoon, the zeroed out CLAT is a way to pass on assets without any gift taxes. To further expand on this technique, one should consider the testamentary zeroed out charitable lead annuity trust (the "TCLAT"). Since there is no limit on the duration of charitable lead annuity trusts, it can be for any fixed term no matter how long. The number of years for the trust term should be for the number of years needed to zero out the remainder interest using as the annuity the dividend income the shares generate. In other words, the TCLAT term will be for the number of years, using the Section 7520 rate at the date of death, where the present value of the dividend income from the shares will equal the value of the shares placed in the TCLAT. Since the primary concern is to maintain voting control, it really does not matter that the TCLAT has a long term, even 50 or more years, especially since there is no financial need for the dividend income generated by the shares in trust.[35]

---

[35] A comprehensive discussion of this technique, and the special self-dealing traps under the private foundation rules, was presented by Diana Zeydel, "*Cutting Edge Estate Planning Techniques: The 99-Year GRAT, Leveraged GRATs, Using Testamentary CLATs to Avoid the Sale of Assets to Pay Estate Taxes and Supercharging Installment Sales to Grantor Trusts"* at the 38th Annual Notre Dame Tax & Estate Planning Institute, Chapter 18 (September 20 and 21, 2012)

XI. IMPACT OF A CHANGING ENVIRONMENT ON ESTATE PLANNING

1. The 6 goals of an estate plan	Briefly mention that saving taxes is only one of the 6 goals and that no one technique can accomplish all of the 6 goals simultaneously
2. The Grantor Trust "Burn." Its dangers and how to mitigate the impact of the burn	Refer to the example in the materials showing that a couple with close to $46,000,000 of investment assets can completely deplete their remaining assets with a discounted $10,000,000 taxable gift to a grantor trust and that there is a concern if they live too long
3. Lock in low interest rates, 9-year notes or 20 year notes?	Since interest rates cannot go any lower, history tells us that 9 years from now the mid-term AFR will be 5% to 6%. So, it is best to lock in the 2.4% long-term AFR for 20 years now. And, a refinancing 9 years from now can raise all sorts of audit problems.
4. Defrosting the underwater freeze	Problems can exist if there are guarantees. Given that there is a chance that the depressed assets may eventually increase in value, consider having the present trust freeze its assets.
5. The only advantage of GRATs	No need for seed money.
6. What type of assets should be used with 2-year rolling GRATs?	2-year rolling GRATs are only appropriate for marketable securities with volatility exposure. Do not use for real estate and interests in family business.
7. The size of the valuation discount: Why a lower discount may be better.	Taking a discount equal to the % the IRS offers in settlement of its valuation audits reduces the audit exposure. Porter disagrees with me on this.
8. Minimum interest rates for intra-family sales	Section 7872 incorporates section 1274(d) which allows the use of the current month and the two proceeding months.
9. Dangers in refinancing notes with interest rates greater than the current AFR	A note with an above market rate of interest is valued at a premium. Thus, there needs to be some consideration for lowering the rate of interest such as increasing principal.
10. The BDIT and consider	

income taxable installment sales so that the BDIT can be funded with more than $5,000.	
11. Private annuity sales to grantor trusts for healthy individuals	Used to provide for the living expenses of the grantor so that the principal providing for the living expenses is never exposed to the estate tax. Use a grantor trust so that there are no income tax consequences.
12. Reality of Sale: Use of guarantees and seed money. Risks of a guarantee. See item #4.	
13. How to extend the long-term compounding of tax-free wealth shifting for someone in their 80s and 90s: Using fixed term CLATs	
13. QPRTs	For very valuable homes, the gift of the remainder interest can be far in excess of $1,000,000. With the $5,120,000 exemption, such large taxable gifts can be made without the payment of any gift taxes.
15. SLATs	Trusts for the benefit of my spouse and my descendants allows the spouse who creates the trust to indirectly have the benefit of the assets in the grantor trust, especially if the "burn" from the payment of the income taxes on the grantor trust's income is too great.
16. Reciprocal trust doctrine	What to have in the trusts to make them different? 1. Special power of appointment in only one trust. 2. Different beneficiaries 3. Different trustees 4. Different distribution standards such as HEMS in only one trust. 5. Different class of assets in each trust. 6. Terminate differently ***7. In the trust that H creates for the benefit of W, have a required monthly distribution to W and no required distribution in the other trust***

XII. Family Limited Partnerships ("FLP") And Capital Shifts

For illustrative purposes, ignore the general partnership interest

1. **Senior contributes $10,000,000 of stocks to a FLP for a limited partnership interest.**

BALANCE SHEET

Assets	Basis	Value		Capital Accounts	Value
Stocks	$8,000,000	$10,000,000		Senior	$10,000,000

2. **Assume a 25% valuation discount for Senior's limited partnership interest.**

3. **Senior gifts a 10% limited partnership interest to Junior. Using the discounted value, Senior reports a $750,000 gift on Senior's gift tax return. Senior's capital account for the 10% interest is transferred to the donee partner.**

BALANCE SHEET

Assets	Basis	Value		Capital Accounts	Value
Stocks	$8,000,000	$10,000,000		Senior	$9,000,000
				Junior	1,000,000
					$10,000,000

4. **The FLP borrows $6,750,000 cash.**

BALANCE SHEET

Assets	Basis	Value		Liability	$ 6,750,000
Stocks	$ 8,000,000	$10,000,000		Capital Accounts	
Cash	6,750,000	6,750,000		Senior $9,000,000	
	$14,750,000	$16,750,000		Junior 1,000,000	$10,000,000 $16,675,000

5. **Value of Senior's 90% limited partnership interest is $6,750,000 (after discounts).**

Note: Senior's capital account remains at $9,000,000.

The FLP distributes the $6,750,000 in complete liquidation of Senior's limited partnership interest.

BALANCE SHEET

Assets	Basis	Value		Liability	$6,750,000
Stocks	$ 8,000,000	$10,000,000		Capital Accounts	
				Senior	Junior
				$9,000,000	$1,000,000
				Less: 6,750,000	-
				$2,250,000	$1,000,000

Since Senior is no longer a partner, what happens to the $2,250,000 of Senior's remaining capital account?

Has Reg. § 1.704-1(b)(2)(ii)(b) been violated?

By adopting the capital account maintenance rules in its partnership agreement (standard boilerplate language found in the forms used for FLPs), what is the amount Senior is entitled to receive upon the liquidation of a partnership interest? Has there been a capital shift? If so, how is the capital shift treated?