PLANNING TECHNIQUES AND CASE STUDIES FOR DEALING WITH UNIQUE ASSETS

by

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State Bar of Texas Advanced Estate Planning and Probate (2001, 2002, 2004-2007, 2011, 2013 – Course Director, 2014-15, 2018)
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State Bar of Texas Advanced Estate Planning Strategies (2009-2012, 2014, 2015 – Course Director)
Heart of America Fellows Institute (2019)
University of Texas – Annual Taxation Conference (2006, 2015)
Estate Planning Council of Central Texas (2017)
DFW Philanthropy in Action (2017)
Texas Tech School of Law Estate Planning and Community Property Law Journal (2009, 2015)
State Bar of Texas 12th Annual Business Law Course (2014)
Tarrant County Bar Association Firm Closing/Retirement Seminar (2014)
State Bar of Texas Charitable Giving Program (2004)
Center for American and International Law - 42nd Annual Program on Wills & Probate Law (2003)
Texas Society of CPAs – Fort Worth Chapter (2000-2007)
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Texas Bankers Association Trust School II (2003-2007; 2012)
State Bar of Texas - State Bar College Summer School (2006)
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CASE STUDY EXAMPLE #1

Creative Use Of Irrevocable Life Insurance Trust And Stock Purchase In Estate and Family Business Succession Planning

IRREVOCABLE LIFE INSURANCE TRUST

- PURPOSES
  - Exclude life insurance proceeds from taxable estate
  - Provide liquidity for estate taxes
  - Replace assets given to charity
- FUNDING
  - Normally Annual Exclusion gifts used to pay premiums
- ATTRIBUTES
  - Irrevocable
  - Life insurance proceeds in Grantor's estate if Grantor dies within three years of transfer of policy to trust
  - Not subject to Generation-Skipping Transfer Tax if exemption applied to trust

CASE STUDY EXAMPLE #1
FACTS

1. ABC Company is a "C" corporation owned by James Founder and Sally Founder. James Founder and Sally Founder have three children, James, Jr., William, and Carol. James, Jr. and William work in the business; Carol is not involved in the business. Each of the Founder children has three children of his/her own.

2. James Founder and Sally Founder are the 100% owners of ABC Company stock (very low tax basis) that has value of $15,000,000.

3. James Founder and Sally Founder, each 65 years old, have combined estates worth $25,000,000, $15,000,000 (60%) of which is ABC stock. The remainder of their estates is illiquid, made up of (i) their home, a ranch, land and building on which ABC conducts business (from which they receive fair market value rental income) and profit sharing account of the Corporation, with a combined value of $10,000,000.

4. Certain James and Sally Founder estate planning goals:
   (i) During their lives:
      (a) Take care of each other; and
      (b) Continue to work in and control the business for the rest of their lives (earning salary and benefits during that time);
   (ii) Upon the death of the survivor:
      (a) Pass their interest in the family business to their two children participating in the business;
      (b) Leave their estates in an equitable manner to their three children;
      (c) Reduce their federal estate taxes; and
      (d) Provide liquidity for the payment of their federal estate taxes.

   The Founders currently have "Simple Wills". A Simple Will leaves all of a person's estate to his or her surviving spouse or to children equally (if spouse not surviving), with no transfer tax planning and no special allocation of ABC Company stock to the two sons working in the family business.

A PLAN

1. The Founders recapitalize ABC's single class of stock (voting common) into voting and non-voting common stock and declare a stock dividend whereby 9 shares of non-voting common stock are issued for each share of voting common stock.

2. The Founders then begin a program of Annual Exclusion gifts of non-voting ABC common stock to each son participating in the business, making an equitable gift annually to their daughter of other property (probably undivided interests in the ranch-not equal gift because of the discount difference). The stock and the ranch interests will receive a valuation discount for both lack of marketability and lack of control. The Founder sons and ABC execute a Buy/Sell Agreement which places stock transfer restrictions on their stock under certain predetermined situations. This restricts the transferability of the stock of the sons and also creates a fair market value opportunity for their stock upon certain circumstances (i.e. death or disability funded with life insurance death benefit and cash value build-up). The Founders will execute a separate Buy/Sell Agreement with the Irrevocable Life Insurance Trust described in 4 below. The Buy/Sell Agreement will require the estate of the Founders (or their successors in interests) to sell and the Irrevocable Life Insurance

Trust to buy the shares of ABC owned by the Founders (or their successors in interest) at the survivor's death. Therefore their stock will not be subject to stock transfer restrictions except at death of survivor. This will create a market after the last to die but will avoid having a market created for it during life or at first death which would affect the valuation discount based on lack of marketability for lifetime or first death gifts/bequests.

3. The Founders execute new Wills to take advantage of the Marital Deduction (i.e. QTIP Trust) and Unified Credit (i.e. Bypass/Exemption Equivalent Trust) allowed to their estates. The Wills benefit only the survivor at the first spouse's death. The children receive the benefits under the Wills only upon the survivor's death. Any stock in the Corporation not gifted during life to the sons participating in the business will not be specifically bequeathed to the sons. The transition of #4 below will deal with stock in the corporation.

4. The Founders create an Irrevocable Life Insurance Trust (i.e. Trust) making their two children working in the business initial trustees and those two children and their children primary beneficiaries. The Irrevocable Life Insurance Trust will purchase a joint and survivor life insurance policy on Mr. and Mrs. Founder to be used by the Trust to purchase ABC stock owned by the estate planning trusts of the first to die and the estate of the survivor as well as provide funds to the estate of survivor by loan or asset purchase to pay estate taxes. The death benefit, if any, in excess of that necessary to purchase ABC stock will be equitably divided among the three children. This excess benefit can be distributed to the three children or maintained in separate trusts for each of the children and their descendants, of which each child is trustee of his/her own trust.

   The death benefit in the Irrevocable Life Insurance Trust will not be subject to federal income or estate tax in the estate of either of the Founders or estates of children or children's children if left in Trust.

   The premium on the joint and survivor life insurance policy will be paid by Annual Exclusion gifts by the Founders to the Irrevocable Life Insurance Trust using the Founders' grandchildren (who are children of the sons working in the business) as Crummey gift beneficiaries and income beneficiaries of Trust while insurance contract exists. The grandchildren are also contemporaneous and successor primary beneficiaries to their parents of the trust benefits from the life insurance (i.e. a Dynastic Trust). Use of some of the federal generation-skipping transfer tax exemption will be required because Dynastic Trust characteristics are desired.

5. Upon the death of the last to die of Mr. and Mrs. Founder, the Irrevocable Life Insurance Trust will use the life insurance proceeds to purchase the ABC stock owned by the estate planning trusts of the first to die and the estate of the survivor. Because of the federal income tax basis adjustment of §1014, no capital gains tax will be paid on the purchase from the Marital Deduction Trust of the first to die or the estate of the survivor. To the extent the purchase is from the Unified Credit/Exemption Equivalent Trust of the first to die, capital gains tax may be paid because §1014 basis adjustment is allowed only at the death of first to die and is not allowed at the survivor's death. The Irrevocable Life Insurance Trust will then own the stock of the corporation that was not gifted to the sons during the Founders' lives. The Founder sons will be co-trustees and equal beneficiaries of the Trust (and the later sole trustee of trust that owns such son's equal stock share) and thereby, along with the stock they each own individually, have equal control of the business. The life insurance proceeds that were paid to the estate planning trusts of the first to die and the estate of survivor will be used to pay the required estate taxes. Any remaining cash, along with the rest of the assets of the Founders, will be divided among the three children. The division will be done so as to provide overall equity in the distribution of the Founders' estates among the three children through a funding formula in the Marital Deduction and Unified Credit/Exemption

Equivalent Trusts of the first to die and the Will of the survivor. The funding formula will not be in the Irrevocable Life Insurance Trust. These provisions allow balancing of assets among the Founder children, considering the value of the assets of the Marital Deduction and Unified Credit/Exemption Equivalent Trusts of the first to die, the assets of the surviving parent's estate, the assets in the Irrevocable Life Insurance Trust and the lifetime gifts to the children.

CASE STUDY EXAMPLE #2

Creative Use of Charitable Remainder Trust and Irrevocable Life Insurance Trust in Estate, Business Succession and Charitable Gift Planning

CHARITABLE REMAINDER TRUST

An irrevocable split interest trust benefiting non-charitable and charitable beneficiaries which:

- Pays no income tax on its income.
- Pays an amount of income and/or principal to the non-charitable beneficiary for CRT term, taxable to the non-charitable beneficiary when received.
- CRT term either a term of years (not to exceed 20) or the lifetime of living individual.
- Pays the remainder to charitable beneficiary at the end of CRT term.
- Provides income, gift, estate and generation-skipping transfer tax charitable deduction to Grantor upon creation and funding.

CHARITABLE REMAINDER ANNUITY TRUST

A charitable remainder trust which:

- Pays a fixed percentage of the initial fair market value of trust assets or specific dollar amount, at least 5% and not more than 50%, to the non-charitable beneficiary - "annuity amount".
- The annuity amount does not fluctuate from year to year.

CHARITABLE REMAINDER UNITRUST

A charitable remainder trust which:

- Pays a fixed percentage of the fair market value of trust assets, valued annually, at least 5% and not more than 50%, to the non-charitable beneficiary - "unitrust amount."

— Standard CRUT – pays fixed percentage

— NICRUT – pays the lesser of income or a fixed percentage

— NIMCRUT – pays the lesser of income or a fixed percentage. The NIMCRUT would contain a provision which would require the trustee to pay deficiencies (the difference between the fixed percentage amount that could have been distributed for a given year but for the income restriction and the amount that was actually distributed, i.e. the income) in future years to the extent the NIMCRUT has income in future years in excess of the fixed percentage amount. Income can include post contribution capital gain.

— FLIP/NICRUT or FLIP/NIMCRUT - combines the annual payment of the lesser of the fixed percentage of the CRUT assets, valued annually, or its income and the annual payment of the fixed percentage of the CRUT assets, valued annually. Until the occurrence of a "triggering event," the FLIPCRUT's annual payment would be the lesser of the fixed percentage of the CRUT assets, valued annually, or its annual income (NICRUT or NIMCRUT). The first taxable year after the occurrence of the triggering event (and for the remainder of the CRUT term), the FLIPCRUT's annual payment would be a fixed percentage of the FLIPCRUT assets, valued annually.

- The unitrust amount increases or decreases annually with the value of the trust assets.

IRREVOCABLE LIFE INSURANCE TRUST

- PURPOSES
  - Exclude life insurance proceeds from taxable estate
  - Provide liquidity for estate taxes
  - Replace assets given to charity
- FUNDING
  - Normally Annual Exclusion gifts used to pay premiums
- ATTRIBUTES
  - Irrevocable
  - Life insurance proceeds in Grantor's estate if Grantor dies within three years of transfer of policy to trust
  - Not subject to generation-skipping transfer tax if exemption applied to trust

CASE STUDY EXAMPLE #2
FACTS

1. ABC Company (ABC or Corporation) is a "C" corporation owned by James Founder and Sally Founder. James and Sally have three children, James Jr., William, and Carol. James, Jr. and William work in the business; Carol is not involved in the business. Each of the Founder children has three children of his/her own.

2. James and Sally are the 100% owners of ABC stock (very low tax basis) that has a value of $9,500,000, including $4,000,000 in cash on which income tax has been paid and that is not necessary for day-to-day operations of the business.

3. James and Sally, each 57 years old and in good health, have combined estates of $15,000,000, $9,500,000 (63%) of which is ABC stock. The remainder of their estates is illiquid, made up of their home, a ranch, land and building on which ABC conducts business (from which they receive fair market value rental income) and profit sharing account of the Corporation, with a combined value of $5,500,000.

4. Certain James and Sally Founder's estate planning goals are:
    a. Immediately remove $4,000,000 in cash from the Corporation and to put it to work for their benefit outside ABC without paying additional income tax;
    b. During the next seven years stay in control of their business as shareholders and directors and continue salary and benefits as employees;
    c. Seven years from now be completely out of ABC as shareholders, directors and employees;
    d. Take care of each other during their lifetime;
    e. At their deaths:
        1) Provide a significant gift to public charity that will not reduce their children's inheritance.
        2) Pass whatever portion of their stock (voting and non-voting) in ABC that has not already gone to their two sons participating in the business to them in the most tax advantageous manner;
        3) Divide their estates equitably among their three children;
        4) Provide liquidity for the payment of these taxes in a tax advantages manner.

The Founders currently have "Simple Wills". A Simple Will leaves all of a person's estate to his or her surviving spouse or to children equally (if spouse not surviving), with no transfer tax planning and no special allocation of ABC Company stock to the two sons working in the family business.

A PLAN

1. James and Sally Founder recapitalize ABC's single class of stock (voting common) into voting and non-voting common stock and declare a stock dividend whereby 9 shares of non-voting common stock are issued for each share of voting common stock.

2. The Founders then begin a program of Annual Exclusion gifts of non-voting ABC common stock to each son participating in the business, making an equitable gift annually to their daughter of other property (probably undivided interests in the ranch – not equal because of discount differences). The stock and ranch interest will receive a valuation discount. The Founder sons and ABC execute a Buy/Sell Agreement which places stock transfer restrictions on their stock under

certain predetermined situations. This restricts the transferability of the stock of the sons and also creates a fair market value opportunity for their stock upon certain circumstances (i.e. death or disability funded with life insurance death benefit and cash value build-up). The Founders will not execute any Buy/Sell Agreement; therefore their stock will not be subject to stock transfer restrictions and will avoid having a market created for it which would affect the valuation discount based on lack of marketability, for lifetime gifts or death transfers.

3. The Founders execute new Wills that at the survivors death leave their sons equally any stock (voting and non-voting common stock) not given during their lives and an equitable amount of other property (probably undivided ranch interests – not equal because of discount differences) to their daughter. Their Wills take advantage of the Marital Deduction and Unified Credit allowed to their estates. The Wills benefit only the survivor at the first spouse's death. The children receive benefit under the Wills only upon the survivor's death.

4. The Founders create an inter vivos Charitable Remainder Unitrust (FLIP/NIMCRUT) and fund it with $4,000,000 (approximately 75%) of the non-voting common stock of ABC. The remaining non-voting stock and all of the voting stock (except for Annual Exclusion gifts) will be retained until the Founders retire from the business at which time they will gift it to their sons, with an equitable gift of the ranch interests to their daughter. This maintains control for James and Sally until they are no longer economically tied to ABC. The non-voting common stock transferred to the FLIP/NIMCRUT will receive a valuation discount (assume 40% -from $6,500,000 million to $4,000,000 million) for both lack of marketability and lack of control. The FLIP/NIMCRUT will have the following attributes:

    a. It will pay an annual payment (Unitrust Amount) to James and Sally and the survivor in an amount equal to six percent of the FLIP/NIMCRUT's value each year or the FLIP/NIMCRUT's income (including post contribution capital gains) for that year, whichever is less (with a make-up in future years in which income is greater than six percent of the Unitrust's value for that year, of the cumulative amount of all prior years' shortfall of net income as compared to six percent of each prior year's value of FLIP/NIMCRUT assets, i.e. make-up amount) for the first ten years. Beginning with the eleventh year the FLIP/NIMCRUT will FLIP (or change) and begin to pay a fixed Unitrust Amount equal to six percent of the value of the FLIP/NIMCRUT's assets annually. At that time, any unrecovered make-up amount will be forfeited.
    b. The Founders will be Trustees of the FLIP/NIMCRUT.
    c. The gift by the Founders to the FLIP/NIMCRUT will not result in any recognition of the capital gain inherent in the non-voting stock given to the FLIP/NIMCRUT.
    d. The FLIP/NIMCRUT gift will generate an income tax charitable deduction equal to the present value of the future (remainder) interest to be given to public charities.

5. Soon after the gift to the FLIP/NIMCRUT, ABC will use its cash to purchase the non-voting stock owned by the FLIP/NIMCRUT at the fair market value (discounted) of the stock at the time of the purchase:

    a. To avoid the excise tax for self-dealing with FLIP/NIMCRUT assets by a disqualified person, ABC must make the same offer to all ABC shareholders of the same class of stock.
    b. All economic relationships (other than reasonable compensation for personal services) between the FLIP/NIMCRUT and disqualified persons must be suspended while the FLIP/NIMCRUT owns Corporation stock, i.e. no rental payments or accrual of payments on Founders land/building leased to Corporation.

c. There must be no legal obligation prior to the stock gift to the FLIP/NIMCRUT that the FLIP/NIMCRUT sells its stock to ABC.

6. The gift, purchase and sale described in 4. and 5. above will have the following attributes:

a. The gift will reduce the value of the Founders' taxable estates by approximately $6,500,000.
b. The subsequent purchase and sale will move cash *free* of federal income tax to the FLIP/NIMCRUT (i.e., there will be no recognition of the gain inherent in the assets sold at the time of the sale by the FLIP/NIMCRUT).
c. The sale will provide liquid assets to the FLIP/NIMCRUT to enable it to diversify its holdings and acquire property that can generate enhanced return for James and Sally. The FLIP/NIMCRUT should invest for growth while the Founders continue as employees of the Corporation to allow Unitrust assets to grow while the Founders have their ABC compensation to provide their support.
d. Some of the Unitrust Amount paid by the FLIP/NIMCRUT as well as the taxes saved by the charitable income tax deduction for the stock gift to the FLIP/NIMCRUT, can be used to offset the cost of the premiums on the life insurance owned by an Irrevocable Life Insurance Trust on the lives of James and Sally described in 7. below.
e. The gift by the Founders and subsequent sale by the FLIP/NIMCRUT to ABC (i.e. corporate redemption) will reduce their issued and outstanding stock of the ABC, thereby increasing the percentage of ABC ownership of the Founder sons working in the business, the last gift of remaining shares of voting and non-voting common stock giving the two sons 100% ownership and control of the business. This results in a federal estate and gift tax-free transfer of ABC ownership to the Founder sons.
f. The purchase by ABC will result in a non-taxable dividend to the FLIP/NIMCRUT that will reduce the Corporation's retained earnings.
g. The Unitrust Amount paid to James and Sally will be characterized to the FLIP/NIMCRUT and taxed to them upon receipt as a redemption dividend because of their continued ownership of ABC, continued control of ABC and their continued employment by ABC. This characterization of Unitrust Amounts as redemption dividends will continue until the full amount of unrecognized redemption gain has been taxed to them as Unitrust Beneficiaries. It is noted if the transaction of this Case Study Example occurs at the time of the retirement of James and Sally Founder, James and Sally terminate all roles with ABC and execute the appropriate Internal Revenue Code waivers, the gain on the transaction will be characterized to the FLIP/NIMCRUT and taxed to James and Sally as long term capital gain.

7. Finally, the Founders create an Irrevocable Life Insurance Trust (Trust) making <u>all</u> of their children trustees and children and grandchildren beneficiaries. The Trust will purchase a joint and survivor life insurance policy on James and Sally in the amount of $6,500,000, plus or minus, an amount sufficient to accomplish the following objectives:
a. To replace the value of the assets given to the FLIP/NIMCRUT.
b. To provide liquidity for the payment of estate taxes.
c. To aid in balancing the estate among the Founder children.
    (1) The death benefit in the Trust will not be subject to federal income or estate tax in the estate of either of the Founders.
    (2) The premium on the joint and survivor life insurance policy will be paid by Annual Exclusion gifts by the Founders to the Trust using <u>all</u> of the Founders' grandchildren as (Crummey) annual withdrawal beneficiaries and contemporaneous income beneficiaries with their parents of the Trust while the

insurance contract exists. This allows the Annual Exclusion gifts by the Founders of other property to be made to the children, i.e. ABC stock to their sons in the business and ranch interests to their daughter.

(3) The grandchildren are also contemporaneous, as well as successor beneficiaries to their parents, of the Trust benefits from the life insurance proceeds (i.e. a Dynastic Trust). Use of some of the federal generation-skipping transfer tax exemption will be required because Dynastic Trust characteristics are desired.

8. Upon the death of the last to die of James and Sally:

a. The FLIP/NIMCRUT will terminate and the assets of the FLIP/NIMCRUT will pass to public charities chosen by James and Sally (as changed from time to time over their lifetimes). The survivor's estate will receive a 100% estate tax charitable deduction for the assets in the FLIP/NIMCRUT that are included in the survivor's estate.

b. The Trust will allocate the insurance proceeds for the benefit of the children and grandchildren, estate and income tax free.

CASE STUDY EXAMPLE #3

Creative Use of Family Limited Partnership, Non-Grantor Charitable Lead Annuity Trust, Intentionally Defective Grantor Trust and Private Foundation in Estate, Business Succession and Charitable Gift Planning

CHARITABLE LEAD TRUST

An irrevocable split interest trust benefiting charitable and non-charitable beneficiaries using present value calculations to leverage transfer tax strategies which:

- Pays an amount of income and/or principal to the charitable beneficiary for its term and pays the remainder to children or others at the end of term;
- Grantor receives a gift or estate tax charitable deduction for the present value of the interest passing to charity;
- Grantor receives an income tax charitable deduction upon creation and funding for the present value of the interest passing to charity if “grantor” charitable lead trust, but does not receive an income tax charitable deduction upon creation and funding if “non-grantor” charitable lead trust;
- Trust pays income tax on trust income during trust term if it is “non-grantor” charitable lead trust with annual income tax charitable deduction and Grantor pays income tax on trust income during trust term if it is “grantor” charitable lead trust, without a corresponding annual income tax charitable deduction; and,
- Charitable beneficiary payment term is a term of years or lifetime of living individual or individuals, with required close relationship to Grantor.

CHARITABLE LEAD ANNUITY TRUST

A charitable lead trust which:

- Pays a fixed percentage of the initial fair market value of trust assets or specific dollar amount (no 5%/50% requirement) to the charitable beneficiary - “annuity amount”.
- The annuity amount does not fluctuate from year to year.

CHARITABLE LEAD UNITRUST

A charitable lead trust which:

- Pays a fixed percentage of the fair market value of trust assets (no 5%/50% requirement), valued annually to charity- “unitrust amount.”
- The unitrust amount increases or decreases annually with the value of the trust assets.

FAMILY LIMITED PARTNERSHIP

Planning tool to own and transfer from one generation to succeeding generations family businesses, real estate interests and investment assets. It can be custom designed to meet each particular family situation. Top ten (10) reasons for selecting the family limited partnership as a planning tool in ascending order of importance:

- Limitation of Payroll Taxes.
- Accumulation of Wealth.
- Family Training in Management and Growth of Assets.
- State Taxes/Income Tax Flexibility.
- Valuation Discount.
- Consolidation of Assets.
- Asset Protection – Inside and Outside of Family Limited Partnership.
- Separate Property Maintenance/Pre-Marital Planning.
- Continuity of Management.
- Control, Control, Control.

Increasingly subject to challenge by the Internal Revenue Service based upon the ability to transfer assets owned by the family limited partnership to succeeding generations at a discounted value. Of particular concern are family limited partnerships utilized to transfer investment assets to the next generation at a discounted value. Areas of possible attack by the Internal Revenue Service include the following:

- Lack of Bona Fide Business Purpose/ Withdrawal Rights.
- "Applicable Restriction" under Section 2704 of the Internal Revenue Code.
- Formalities of Partnership.
- Gift Upon Creation.
- Step Transaction Doctrine.
- Single Testamentary Transaction.
- Bona Fide Sale/Adequate, Full Consideration – 2036 (a)

PRIVATE FOUNDATION

A non-profit corporation or irrevocable trust which:

- Receives charitable contributions from its creator and others.
- Enables donor to receive an income tax charitable deduction for property contributed during life:
    - Deduction limited to 30% of donor's adjusted gross income for gift when donation is cash
    - Deduction limited to 20% of donor's adjusted gross income for gift of appreciated qualified publicly traded stock when donation is attributed to value of the qualified publicly traded stock
    - Deduction limited to 20% of donor's adjusted gross income for gift of appreciated property, other than qualified publicly traded stock, and donation is attributed to basis of donated asset
- Enables donor to receive a full estate, gift and GST tax charitable deduction for property contributed.
- Makes annual grants to public charity, as selected by the foundation's board of directors, in an amount equal to at least 5% of the annual fair market value of foundation's assets.
- Pays a 2% excise tax (can be reduced to 1%) annually on investment income.

GRANTOR RETAINED INTEREST TRUST:
"GRIT", "GRAT", "GRUT","PRT", OR "QPRT"

An irrevocable trust of which:

- The grantor is the owner of the trust for income tax purposes
- The grantor is <u>not</u> the owner of the trust for estate tax purposes unless the grantor dies during the trust term
- The grantor is the owner of the trust for GST tax purposes until the end of the trust term
- Gift to the GRT migrates wealth to the next generation at a leveraged gift tax cost if grantor retains a qualified interest
- If the grantor survives the end of the GRT term and GRT investment goals are met, the value of the gift to children upon the creation of the GRT is significantly less than the value of the assets when the GRT is terminated

INTENTIONALLY DEFECTIVE GRANTOR TRUST ("IDGT")

An irrevocable trust of which:

- The grantor (or in certain cases beneficiary) is the owner of the trust for income tax purposes
- The grantor is <u>not</u> the owner of the trust for gift, estate or GST tax purposes

INTENTIONALLY DEFECTIVE GRANTOR TRUST ("IDGT") – GIFT/SALE

A part sale/part gift transaction of which:

- The grantor creates the IDGT
- The grantor funds the IDGT with an amount at least equal to 10% of amount to be purchased through a deferred payment option – "coverage"
- The grantor (or in certain cases beneficiary) sells assets to the IDGT in exchange for cash or a deferred payment option - promissory note, SCIN or private annuity
  - Promissory note – flexible terms, interest rate must be at least the appropriate applicable federal rate; unpaid balance of note in estate upon death; certain income tax issues upon death
  - Self-canceling installment note – premium paid for self-canceling feature; no estate inclusion but certain income tax issues upon death
  - Private annuity – no estate inclusion or income tax issues upon death
- Migrates wealth to the next generation at a leveraged transfer tax cost

CASE STUDY EXAMPLE #3
FACTS

1. James Founder and Sally Founder have three children, James Jr., William, and Carol, none of whom work in the family business. Each of the Founder children has three children of his/her own.

2. Over the years, James and Sally have made Annual Exclusion gifts (no Lifetime Exemption gifts) to their three children of family business stock, undivided interests in the family ranch and oil and gas interests. Recently the family business was sold to a major competitor for a net after tax amount of $10.0 million. The Founders received $7.6 million. Each child received $800,000.

3. James and Sally Founder, each 65 years old and in good health, have combined estates worth $20.0 million, $7.6 million of which is cash from the sale of their family business. The remaining $12.4 million of their estates is made up of their home, a ranch, and IRA retirement plan rollover account from the family business, stock and bond investments, and oil and gas interests.

4. The Founders recognize the existence of substantial economic opportunities in the marketplace for acquisition of businesses, real estate and other investments. They want to use a substantial amount of the cash they received from the sale of their family business to acquire differing assets but have concerns about the liability of acquired operations affecting other assets in their estate. In addition, they want their children and grandchildren to be able to share in the benefits from their investments, as well as their beliefs concerning the responsibility of wealth and their philosophy regarding philanthropy. The Founders want to retain control of their assets during their lives. Further, James and Sally Founder would like to create the Founder Family Foundation (Foundation) and provide approximately $2.0 million to it in seed funding for future charitable activities of the Founder family. The Founders want to do all of the above in a manner that will give their family and private philanthropy the greatest economic benefit.

5. The Founders have located what they analyze to be an excellent investment opportunity in the commercial real estate market. They plan to acquire certain commercial real estate that they believe will triple the cost to acquire over the next 10 years. The purchase price of the real property is $3.5 million. It is anticipated that the property will produce $350,000 a year in net cash flow, with financially stable lessees, under long term, FMV adjusting leases.

A PLAN

1. James and Sally and their three children create Founder Family Investments, L.P. (partnership) for a set term of years, Founder Management, L.L.C. (limited liability company) and transfer cash to the partnership and limited liability company, as follows:
    a. The James and Sally contribute $3,550,000 to partnership (i.e. collectively 88.75% interest).
    b. Each child contributes $150,000 to partnership (i.e. collectively 11.25% interest).
    c. The Founders and their children receive limited partnership interests totaling 100% of value of the assets of the partnership for their contributions.
    d. Founder Management, L.L.C. owned by the Founders and their children, receives a zero equity 0% general partnership interest, making no contributions of its cash to the partnership. James and Sally retain control, children follow in control, of the LLC and thereby the partnership for their lives.

2. The partnership agreement provides that major actions of the partnership (i.e. liquidation, sale of substantially all of the assets or distributions of cash in excess of the income of the partnership) require the approval of both types of the partnership interests, both limited partnership interests and the general partnership interest.

   a. The partnership agreement also provides that all distributions from the partnership are made on a pro rata basis of all partnership interests to avoid the prohibited transaction of a disqualified person (Founders) and a private foundation (CLAT described below) participating in direct or indirect self-dealing resulting from a deemed purchase and sale of partnership interests upon a non-pro rata distribution resulting in an adjustment of partnership interests among the partners. The Founders should be careful to make sure that the partnership operationally complies with this restriction.

3. The partnership purchases the commercial real estate for $3.5 million cash.

4. The Founders create a Non-Grantor Charitable Lead Annuity Trust (CLAT):

   a. The Founders gift substantially all of their limited partnership interests (i.e. 88% of the Founders' interest) equal in value to $1.875 million to the CLAT. The Founder limited partnership interests transferred to the CLAT represent an 78% share of the underlying real estate/cash valued at approximately $3.125 million. The limited partnership interests are assumed for this Case Study, to be entitled to a 40% discount from the value of the real estate owned by the partnership.
   b. The CLAT requires the payment for 10 years of a 10% annuity to the Foundation or $187,500 a year. Therefore, total payments to the Foundation over the 10 years will be $1.875 million.
   c. At the end of the CLAT term its limited partnership interests will pass to the Founder children.
   d. A gift to the CLAT of limited partnership interests will not provide the Founders with a current income tax charitable deduction; however, because the Founders retain no power to control beneficial enjoyment of income or corpus and retain no future benefit from the CLAT, they will receive a 100% gift tax charitable deduction for the present value of the Foundation's interest in the CLAT, $1.775 million and the CLAT limited partnership interest will be removed from the Founders' taxable estate.
   e. Because of this intervening charitable interest in the CLAT, the present value of the future interest gift to the Founder children through the CLAT is discounted by approximately 88% under the Treasury Tables[1]. Therefore, the gift to the children at the time of the creation/funding of the CLAT will be $99,131, approximately 3.1% of the $3.125 million value of the underlying real estate/cash of the partnership attributed to the limited partnership interests of the Founders, resulting in an 96.9% leveraged future interest gift to the Founder children.
   f. Because the gift to the Founders' children is a future interest gift, the Founders' Lifetime Exemption (not their Annual Exclusions) will be used to preclude the gift tax associated with the gift.

5. The Founder Family Foundation will be created by the children of James and Sally Founder. James and Sally will be neither members, officers nor directors of the Foundation. By so creating the Foundation, James and Sally can make the annuity distributions from the CLAT mandatory to the Foundation, place the children as trustees of the CLAT and in charge of the Foundation. This is

[1] Assumes a §7520 rate of 1.1% (October 2021)

part of the process of James and Sally to educate their children concerning the responsibility of wealth and their philosophy regarding philanthropy.

6. Then, as above stated, at the end of the CLAT term (10 years after creation), the CLAT will terminate and the limited partnership interests will be distributed to the Founder children. Presuming the projections are realized and the real property triples the Founder's cost, the Founder children will receive limited partnership interests with an underlying real estate asset value of approximately $9 million. This wealth migration, which is net of $1.875 million to the Foundation, resulted from a transfer of limited partnership interests with a gift tax value of approximately $99,131 to the CLAT ten years before. The leverage in this wealth migration transaction is 98.9%, i.e. for gift tax purposes, the transfer is $.011 on $1.00 of underlying partnership asset value transferred to the children ten years after creation and funding of the CLAT. Thus, by use of the CLAT, the partnership, the limited liability company, and the Foundation, the Founders insulated non-partnership wealth from liability, retain control of their assets, satisfy their private philanthropy objectives and transfer significant value to their children with no federal gift or estate tax cost.

7. It should be noted that because the present value of the Foundation's portion of the CLAT assets exceeds 60% at the initiation of the CLAT, the private foundation excess business holdings rule could apply. In the Facts of this Case Study Example, that will not create a problem because all (could not be less than 95%) of the limited partnership income is commercial rental real estate leasehold income (i.e. passive income, not income from an active trade or business), and therefore the limited partnership is not a business enterprise for private foundation excess business holdings rule purposes.

8. Also, because the limited partnership is not an active trade or business and there is no debt in the limited partnership that contributes to the earning of income of the partnership (i.e. $500,000 side fund established upon initiation of limited partnership), there is no unrelated business income generated from either an active trade or business or debt financed property; consequently, the full 100% income tax charitable deduction will be allowed CLAT income.

9. CLAT income can include capital gain because the CLAT agreement allows the CLAT trustee the discretion to allocate CLAT capital gain to income or to principle, as normally provided in the applicable state trust statute.

10. It is anticipated that the commercial real property will produce $350,000 of net cash flow each year, approximately $273,000 (i.e. 78%) of which could be distributed by the partnership to the CLAT as it's pro rata share of partnership income, in satisfaction of annual annuity payment of $187,500.
    a. The income of the partnership in excess of the pro rata distribution to all partners, including to the CLAT to allow the CLAT to make its annual annuity payment to the Foundation, can be retained in the partnership for the future needs of the real estate activity of the partnership (so borrowing will not be necessary).
        (1) If funds are borrowed to support the real estate activities of the partnership, the income of the partnership can become unrelated business income that could result in unrelated business taxable income causing a reduced income tax charitable deduction for the CLAT.
        (2) Additional contributions to the partnership by partners may not be allowed because:
            (a) A pro rata contribution by the partners is not possible unless the CLAT's contribution is from partnership distributions accumulated in the CLAT or created upon initiation of CLAT by gift to create a CLAT cash side fund

(i.e. this not done in Case Study, $500,000 is limited partnership side funded), because the Founders are prohibited from making additional contributions to the CLAT;

(b) A non-pro rata contribution by the LLC or Founders could be a prohibited indirect self dealing act of the partners resulting in adjustment of partnership capital accounts.

11. A CLAT (but not a CLUT) has limited value for generation-skipping transfer tax purposes.

    a. Under IRC § 2642(e), the generation-skipping transfer tax exemption is applied against the value of CLAT assets at the end of the CLAT term. The exemption amount established/used at that time is the generation-skipping transfer tax exemption put in place at the time of the initiation of the CLAT, compounded annually at the Treasury Table rate used in determining the charitable deduction. Presuming this annual rate is such that the exemption amount at the CLAT termination is less than the value of CLAT assets at that time, the generation-skipping transfer tax inclusion ratio will be other than zero, resulting in a taxable termination as to the assets of the CLAT at the end of the CLAT term to the extent the CLAT remainder beneficiaries are at least two generations below the Founders if the move-up rule did not apply at the time of the initiation of the CLAT. If the annual rate is such that the exemption amount at the CLAT termination is more than the value of the CLAT assets at the time, the generation – skipping transfer tax inclusion ratio will be zero but generation – skipping transfer tax exemption will have been wasted.

    b. To address this shortcoming in the CLAT as a wealth migration tool, the Founder children could sell their remainder interests in the CLAT to separate generation-skipping, intentionally defective grantor trusts (IDGT) that are created and funded by their parents. The IDGTs could be created to be grantor trusts as to the Founder children by James and Sally making Annual Exclusion gifts to each IDGT that targets the Founder children as the Annual Exclusion (Crummey) withdrawal beneficiaries. The IDGTs could be created to be grantor trusts as to James and Sally Founder by James and Sally Founder making Lifetime Exemption gifts to each IDGT. To allow the remainder interest sale by the Founder children to the IDGTs, a special drafting consideration of the CLAT will be the modification of the "Spendthrift" provision from the CLAT document. Due consideration, however, should be given to the Service's current position on any attempt to thwart the application of the generation-skipping transfer tax where a remainder interest in a CLAT is gifted by a non-skip person to a skip person, including a generation-skipping trust. PLR 200107015.

CASE STUDY EXAMPLE #4

Creative Use Of Intentionally Defective Grantor Trust, Family Limited Partnership And Irrevocable Asset/Life Insurance Trust In Family Business Succession And Wealth Migration Planning

IRREVOCABLE ASSET/LIFE INSURANCE TRUST

- PURPOSES
  - Exclude assets including life insurance proceeds from taxable estate
  - Provide liquidity for estate taxes
  - Replace assets given to charity
- FUNDING
  - Normally Annual Exclusion gifts used to pay premiums
  - Lifetime credit and taxable gifts
- ATTRIBUTES
  - Irrevocable
  - Life insurance proceeds in Grantor's estate if Grantor dies within three years of transfer of policy to trust
- Not subject to Generation-Skipping Transfer Tax if exemption applied to trust

FAMILY LIMITED PARTNERSHIP

Planning tool to own and transfer from one generation to succeeding generations family businesses, real estate interests and investment assets. It can be custom designed to meet each particular family situation. Top ten (10) reasons for selecting the family limited partnership as a planning tool in ascending order of importance:

- Limitation of Payroll Taxes
- Accumulation of Wealth
- Family Training in Management and Growth of Assets
- State Taxes/Income Tax Flexibility
- Valuation Discount
- Consolidation of Assets
- Asset Protection – Inside and Outside of Family Limited Partnership
- Separate Property Maintenance/Pre-Marital Planning
- Continuity of Management
- Control, Control, Control

Increasingly subject to challenge by the Internal Revenue Service based upon the ability to transfer assets owned by the family limited partnership to succeeding generations at a discounted value. Of particular concern are family limited partnerships utilized to transfer investment assets to the next generation at a discounted value. Areas of possible attack by the Internal Revenue Service include the following:

- Lack of Bona Fide Business Purpose/ Withdrawal Rights
- "Applicable Restriction" under Section 2704 of the Internal Revenue Code
- Formalities of Partnership
- Gift Upon Creation
- Step Transaction Doctrine
- Single Testamentary Transaction
- Bona Fide Sale/Adequate, Full Consideration – 2036 (a)

INTENTIONALLY DEFECTIVE GRANTOR TRUST ("IDGT")

An irrevocable trust of which:

- The grantor (or in certain cases beneficiary) is the owner of the trust for income tax purposes
- The grantor is not the owner of the trust for gift, estate or GST tax purposes

INTENTIONALLY DEFECTIVE GRANTOR TRUST ("IDGT") – GIFT/SALE

A part sale/part gift transaction of which:

- The grantor creates the IDGT
- The grantor funds the IDGT with an amount at least equal to 10% of amount to be purchased through a deferred payment option – "coverage"
- The grantor (or in certain cases beneficiary) sells assets to the IDGT in exchange for cash or a deferred payment option - promissory note, SCIN or private annuity
    - Promissory note – flexible terms, interest rate must be at least the appropriate applicable federal rate; unpaid balance of note in estate upon death; certain income tax issues upon death
    - Self-canceling installment note – premium paid for self-canceling feature; no estate inclusion but certain income tax issues upon death
    - Private annuity – no estate inclusion or income tax issues upon death
- Migrates wealth to the next generation at a leveraged transfer tax cost

CASE STUDY EXAMPLE #4
FACTS

1. Founder family farm and ranch land is owned individually by James Founder and Sally Founder. James and Sally have two children: James, Jr. and Carol. James, Jr. works the farm with his father; Carol is not involved in the farming business. Each of the Founder children has three children of their own.

2. The farm and ranch land that James Founder and Sally Founder own consists of land that was inherited and purchased over the past 40 years.

3. The land is divisible between that portion used for farming and that portion used for hunting and fishing, both personally and leased to third parties. James Founder and Sally Founder own 100% of the underlying minerals of the land.

4. Certain James and Sally Founder estate planning goals:
   - (a) Take care of each other;
   - (b) Transfer farming operations to James, Jr.;
   - (c) Protection from creditors, including protection from marital discord in the children's and grandchildren's marital relationship;
   - (d) Treat the children equitably;
   - (e) Reduce their federal estate taxes; and
   - (f) Provide liquidity for the payment of these taxes.

A PLAN

1. You first advise James Founder and Sally Founder that if they want control and want to protect the property from creditor-related liability and children marital issues, that they should sever the mineral interest from the surface and separate the farming operations from the portion of the land used for hunting and fishing and transfer each of the three property interests (minerals, farm surface and hunting/fishing surface) to a separate limited partnership ("LP") with a limited liability company ("LLC") as the general partner ("GP"). Additionally, they should establish a separate limited liability company for farming operations ("Operations LLC") and transfer employees, equipment and operations.

   a. James Founder and Sally Founder will be owners of each LP, 50%, and GP-LLC 50%, each.
   b. James Founder and James Founder, Jr. will be owners of the Operations LLC.
   c. Management – Each LP (Minerals LP, Farm LP and Ranch LP) will be managed by the GP-LLC as a 0% GP; James Founder and Sally Founder 50/50 have the choice to appoint either of the kids, both of the kids or some other person as their successor managers.
   d. The LPs do not provide for partners to withdraw from the LP.
   e. The partnership agreements provide that major actions of the partnership (i.e. liquidation, sale of substantially all of the assets or distributions of cash in excess of the income of the partnership) require the approval of both types of the partnership interests, both limited partnership interests and the general partnership interest.
   f. The Operations LLC will lease the land from the Farm LP under a triple net lease.

2. It is decided through discussion that the best way to make transfers is to transfer the interests in trust. You recommend that James Founder and Sally Founder create two trusts, one a regular irrevocable asset trust ("IAT"; taxed as a complex trust) and the other a Settlor Intentionally Defective Grantor Trust ("S-IDGT"). The S-IDGT will have a provision that enables James and

Sally to have the power to substitute assets of the S-IDGT with assets having an equivalent value without the approval or consent of any person or entity in a fiduciary capacity. The IAT will be a basket trust for the benefit of their children and more remote descendants. The S-IDGT will be for the benefit of James, Jr., and his children/descendants.

a. James, Jr., and Carol will be Co-Trustees of the IAT. The successor trustees will mirror the LLC general partner manager succession so that control of the family entities is consistent.
b. James, Jr. will be the Trustee of the S-IDGT and have the ability to appoint his successors. James Founder and Sally Founder will be the "grantors" of the S-IDGT meaning they will be the taxpayers for federal income tax purposes.

3. James Founder and Sally Founder then begin a program of Annual Exclusion gifts of cash, limited partnership interests in the Minerals Partnership and/or the Ranch Partnership to the IAT. The limited partnership interests will receive a valuation discount for both lack of marketability and lack of control. Typically you can assume a 30% discount on the limited partnership interests.

4. James Founder and Sally Founder execute new Wills leaving, at the survivor's death, the Operations LLC and any limited partnership interests in the Farm LP not given during their lives to their son and an equitable amount of other property (i.e. limited partnership interests in Minerals Partnership and the Ranch Partnership) to their daughter, or to the trusts already in existence. Their Wills take advantage of the Marital Deduction, Unified Credit/Exemption Equivalent and Generation-Skipping Transfer Tax Exemption amounts allowed to their estates. The Wills benefit only the survivor at the first spouse's death. The children receive benefits under the Wills only upon the survivor's death.

5. James Founder and Sally Founder will then make a gift utilizing a portion of their Unified Credit/Exemption Equivalent and their generation-skipping transfer tax exemption amounts to the S-IDGT. Ten percent (10%) of the value to be sold below ("Coverage").

   Next, James Founder and Sally Founder sell their limited partnership interests in the Farm LP to the S-IDGT in exchange for a promissory note. The promissory note will require the payment of interest only at the mid-term AFR for nine years (10/2021: .91%), and at the end of the nine-year term, the balance of the promissory note will be due.

   The lease payments from the Farm Operations LLC to the limited partnership holding the farm surface can be distributed to the limited partner (i.e. the S-IDGT) and then used by the S-IDGT Trustee for interest payments or accumulated. At the end of the ninth year when the promissory note balance is due, the partnership accumulated lease payments can be distributed to the S-IDGT and used to pay off the note or the S-IDGT could renegotiate the note.

6. The IAT can be used as a life insurance trust. The trust will purchase a joint and survivor life insurance policy on James Founder and Sally Founder to be used by the Trust to provide the daughter an equitable benefit with that provided to their son under the S-IDGT, or provide liquidity for estate taxes, if any. The death benefit in the IAT will not be subject to federal income or estate tax in the estate of either of the Founders.

7. Upon the death of the last to die of James Founder and Sally Founder, the IAT will use the life insurance proceeds for the benefit of their daughter and her descendants. After payment of federal estate taxes, the remaining assets of the Founders' estates will be divided between the two children. The division will be done so as to provide overall fairness (equity, not necessarily equality) in the distribution of the Founders' estates to the two children through a funding formula in the Marital

Deduction Trust, the Unified Credit/Exemption Equivalent Trust of the first to die and the Will of the survivor and the IAT. These provisions allow balancing of assets between the Founder children considering the value of the assets of the Marital Deduction and Unified Credit/Exemption Equivalent Trusts, the value of the partnerships, the IAT, lifetime gifts and the surviving parent's estate.

Planning Alternative – Beneficiary Intentionally Grantor Trust

1. Sally Founder's parents or sibling create and fund an irrevocable asset trust, as a Beneficiary Intentionally Defective Grantor Trust ("B-IDGT"), for James Founder, Sally Founder and their descendants. The family member creating the B-IDGT will make a nominal cash gift to the new trust that will not exceed their Annual Exclusion Amount (that does not exceed the annual lapse amount - no gift tax return will need to be filed) and the B-IDGT will give James Founder a withdrawal right to the gift. James Founder, Sally Founder and their descendants are beneficiaries of the B-IDGT. James Founder is the Trustee of the B-IDGT. The B-IDGT will be taxed to James Founder for income tax purposes.

2. James Founder sells to the B-IDGT a specific dollar amount (i.e. Defined Value) in a portion of his limited partnership interests in some or all of the limited partnerships (i.e. 50%). The balance of such 50% interest is gifted to a three year Grantor Retained Annuity Trust ("GRAT"). The transaction has two components: 1) a "defined value sale" to the B-IDGT in exchange for a promissory note and 2) a gift of the remaining interests above the "defined value amount" to the GRAT. One of the partnerships will guarantee the B-IDGT note to James Founder, to the extent of 10% of its face ("Coverage") and receive an annual guarantee fee.

3. The promissory note will require the payment of interest only at the mid-term AFR for nine years (10/2021: .91%), and at the end of the nine-year term, the balance of the promissory note will be due.

4. The GRAT will be a three-year GRAT and will make annual annuity payments to James Founder on the anniversary of the funding of the GRAT for the next 3 years. The annuity payments can be in-kind (i.e. the limited partnership interests received from the gift).

CASE STUDY EXAMPLE #5

Creative Use of Settlor Intentionally Defective Grantor Trust ("S-IDGT") In A Gift/Sale Transaction

CASE STUDY EXAMPLE #5
Facts

1. Clients, Mr. and Mrs. Smith, are 65 and 64, respectively.
2. Mr. and Mrs. Smith have 1 son (who has two children) and 1 daughter (who has three children)
3. Mr. and Mrs. Smith own 400 acres of farm land that was purchased by Mr. and Mrs. Smith 40 years ago. The land is used for farming by the family. The property is owned equally as tenants in common (separate property of each of Mr. and Mrs. Smith).
4. Mr. and Mrs. Smith own 100% of the underlying minerals of the farm land.
5. Mr. and Mrs. Smith have been approached by Big Time Oil Company regarding possibly signing a drilling lease. The lease bonus discussed is $2,500 per acre ($1,000,000) and the royalty discussed is 25%.
6. Mr. and Mrs. Smith heard at church that they should consider discussing with an attorney what they should do before signing anything, and they have come to your office for assistance.
7. After a short discussion with Mr. and Mrs. Smith, you learn that they would like to receive a portion of the benefits of any oil and gas lease, but would also like to share the revenue with their children and grandchildren to provide a life for them that Mr. and Mrs. Smith never had. Other than that, they would also like to have some type of protection from creditors and protection from marital discord in children's and grandchildren's marital relationships, and obviously, would like to pay as little tax as possible. They would also like to maintain some type of control.
8. Mr. and Mrs. Smith are particularly concerned about their son's financial responsibility, and do not want him to be able to control the assets or funds that he may receive.

A Plan

1. You first advise Mr. and Mrs. Smith that if they want control and want to protect the royalty interest they will receive from creditor-related liability and children marital issues, that they should sever the mineral interest from the surface (i.e. vertical severance) and transfer the mineral interest to a new limited partnership ("LP") with a limited liability company ("LLC") as the general partner ("GP").

2. Mr. and Mrs. Smith will be owners of the LP, 49.5%, and LLC 50%, each.

3. Management – The LP will be managed by a LLC as a 1% GP; Mr. and Mrs. Smith 50/50 have the choice to appoint either of the kids, both of the kids or some other person as their successor managers.

4. The LP does not provide for partners to withdraw from the LP.

5. After Mr. and Mrs. Smith create the LP and the LLC and transfer the minerals into the LP, the LP signs the Oil and Gas Lease with Big Time Oil Company and LP receives the check for $1,000,000.

   - Now that the control structure has been put into place for Mr. and Mrs. Smith regarding the mineral interests, you discuss with them the process of transferring a portion of the LP to benefit the children and grandchildren. You explain to Mr. and Mrs. Smith that they could transfer a portion now, without knowing how much they will be receiving in royalties or when, or they can wait until the minerals start producing royalties. The benefit of transferring the LP now is that it would receive a lower appraisal value than if the minerals are producing

6. Mr. and Mrs. Smith determine that they want to go ahead and transfer 50% of the LP for the benefit of their children and grandchildren.

7. It is decided through discussion that the best way to make this transfer is to transfer the interests in trust. You recommend that Mr. and Mrs. Smith create two Settlor Intentionally Defective Grantor Trusts ("S-IDGT"), one for each of their children and their descendants.

8. Since Mr. and Mrs. Smith own their LP interests as separate property, Mr. Smith will create the IDGT for his daughter ("Daughter IDGT") and Mrs. Smith will create the IDGT for her son ("Son IDGT").

9. Mr. Smith will be the initial Trustee of Daughter IDGT and daughter will be the successor Trustee and have the ability to appoint her successors. Mr. Smith will be the "grantor" of Daughter IDGT (i.e. Settlor-IDGT), meaning he will be the taxpayer for federal income tax purposes.

10. Mrs. Smith will be the initial Trustee of Son IDGT and Big Trust Company will be the successor Trustee. Son will have the ability to remove and replace corporate trustees. Mrs. Smith will be the "grantor" of Son IDGT (i.e. Settlor-IDGT), meaning she will be the taxpayer for federal income tax purposes.

    - Now that the trusts are created, Mr. and Mrs. Smith hire Mineral Appraisers Inc. to appraise the non-producing minerals. Mineral Appraisers Inc. will review the lease and other development activity, to provide a value for the minerals. The appraiser settles on a value of $1,500,000 for the mineral estate value.
    - Mr. and Mrs. Smith then hire Business Valuations R' US to value the interests to be transferred. Mr. and Mrs. Smith are each transferring 25.5% of the LP interests (25% of the partnership equity) to the respective IDGT. The underlying asset value of the LP is $2,500,000 (minerals of $1,500,000 and cash from lease bonus of $1,000,000). Business Valuations R' US determine that the value of 25% limited partnership interest in the LP is $418,750, applying a 33% cumulative discount for lack of marketability and lack of control.
    - Mr. and Mrs. Smith make the following transactions:

11. Mr. Smith makes a gift of 3% of the LP ($50,250 value) to Daughter IDGT for "Coverage." Then Mr. Smith sells 22.5% of the LP interests ($368,500) to Daughter IDGT in exchange for a 9 year non-negotiable promissory note, paying interest only for years 1-8 with principal and interest due at the end of year 9. The interest rate on the promissory note (with prepay privileges) is at the mid-term applicable federal rate (0.91% in October 2021).

12. Mrs. Smith makes a gift of 3% of the LP ($50,250 value) to Son IDGT for "Coverage." Then Mrs. Smith sells 22.5% of the LP ($368,500) to Son IDGT in exchange for a 9 year non-negotiable promissory note, paying interest only for years 1-8 with principal and interest due at the end of year 9. The interest rate on the promissory note (with prepay privileges) is at the mid-term applicable federal rate (0.91% in October 2021).

Wealth shift

- After the sale transaction, Mr. and Mrs. Smith each own 25% of the LP (24.5% directly and 50% of the LLC that owns 1%). Daughter IDGT and Son IDGT each own 25% of the of the LP.

- LP owns the following royalties in the years following the transaction and the royalties are allocated to the ownership as follows:

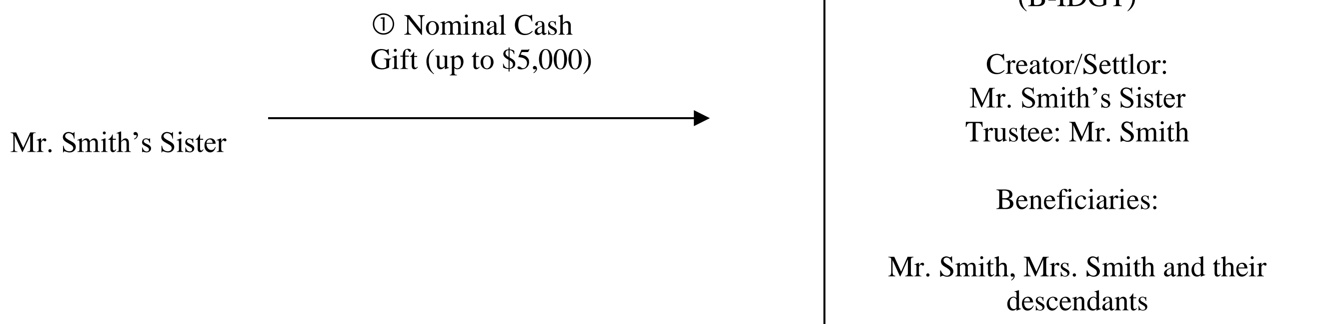
	Total Royalties	Mr. Smith 25%	Mrs. Smith 25%	Daughter Trust 25%	Son Trust 25%
Year 1	$ 300,000	$ 75,000	$ 75,000	$ 75,000	$ 75,000
Year 2	$ 500,000	$ 125,000	$ 125,000	$ 125,000	$ 125,000
Year 3	$ 600,000	$ 150,000	$ 150,000	$ 150,000	$ 150,000
Year 4	$ 800,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000
Year 5	$ 1,000,000	$ 250,000	$ 250,000	$ 250,000	$ 250,000
Year 6	$ 1,000,000	$ 250,000	$ 250,000	$ 250,000	$ 250,000
Year 7	$ 950,000	$ 237,500	$ 237,500	$ 237,500	$ 237,500
Total	$ 5,150,000	$ 1,287,500	$1,287,500	$ 1,287,500	$ 1,287,500

- Based upon the royalties over the next 7 years, Daughter IDGT and Son IDGT will earn more than enough in royalties to pay back Mr. and Mrs. Smith on the promissory notes. During the time the promissory notes are being paid by the IDGTs to Mr. and Mrs. Smith, Mr. and Mrs. Smith will be responsible for the income taxes of the IDGTs. After the promissory notes are satisfied, Mr. and Mrs. Smith, if they desire, can stop paying taxes on the IDGTs and let the IDGTs be responsible for their own taxes.

CASE STUDY EXAMPLE #6

Creative Use Of The Beneficiary Intentionally Defective Grantor Trust ("B-IDGT") Sale and Grantor Retained Annuity Trust ("GRAT") Gift Transaction

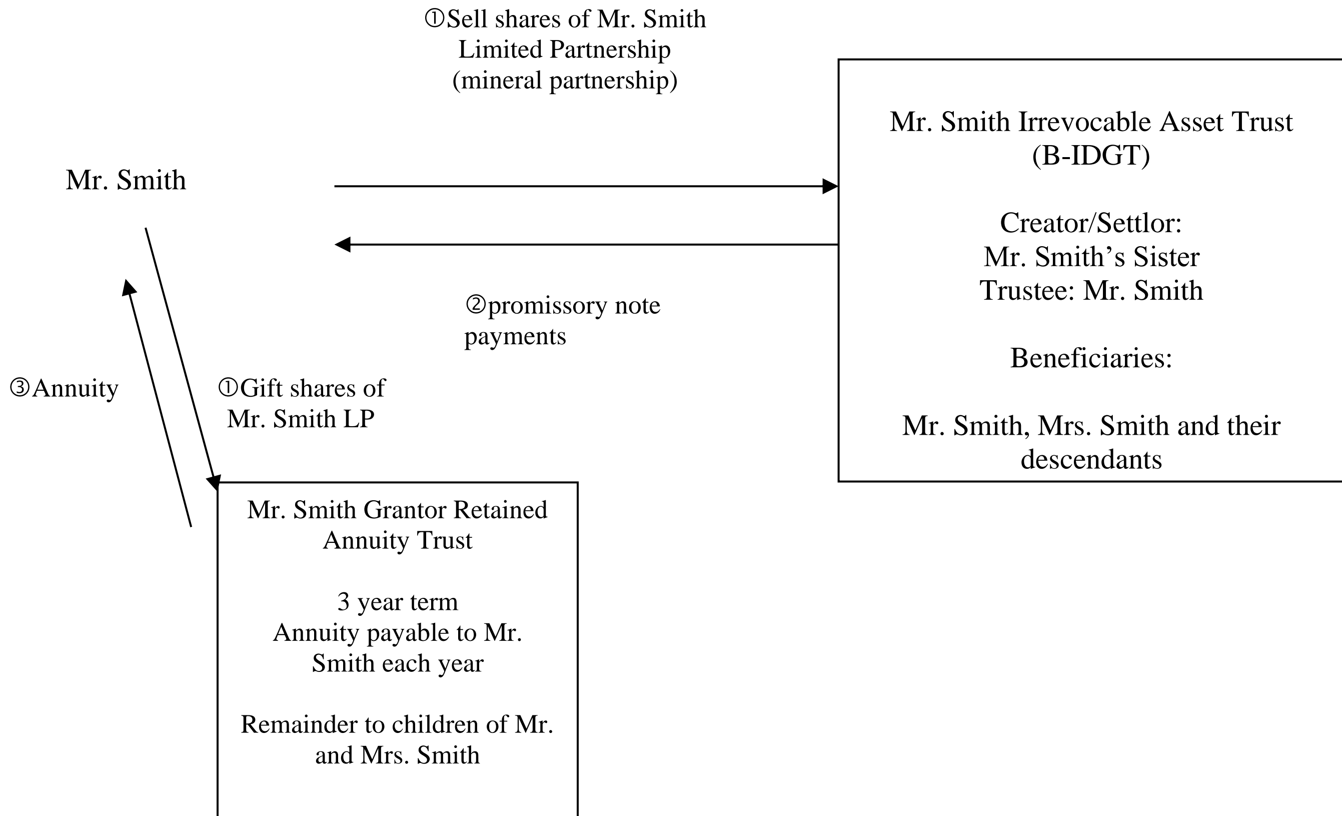
CASE STUDY EXAMPLE #6



Transaction Steps

① Mr. Smith's sister ("Sister") creates and funds an irrevocable asset trust, as an Beneficiary Intentionally Defective Grantor Trust ("B-IDGT"), for Mr. Smith, Mrs. Smith and their descendants. Sister will make a nominal cash gift to the new trust that will not exceed her Annual Exclusion Amount (that does not exceed the annual lapse amount - no gift tax return will need to be filed) and the B-IDGT will give Mr. Smith a withdrawal right to the assets. Mr. Smith, Mrs. Smith and their descendants are beneficiaries of the B-IDGT. Mr. Smith is the Trustee of the B-IDGT. The B-IDGT will be taxed to Mr. Smith for income tax purposes.

B. PHASE II – WEALTH MIGRATION



Transaction Steps

① Mr. Smith sells to B-IDGT a specific dollar amount (i.e. Defined Value) in a 26% interest (or some other partial interest) in Mr. Smith LP. For purposes of this illustration, it is assumed the dollar amount sold to B-IDGT is equal to a 25% interest in Mr. Smith LP. The balance of such 26% interest (i.e. 1%) is gifted to a three year Grantor Retained Annuity Trust ("GRAT"). The transaction has two components: 1)a "defined value sale" to the B-IDGT in exchange for a promissory note and 2)a gift of the remaining interests above the "defined value amount" to the GRAT. Another Smith entity will guarantee the B-IDGT note to Mr. Smith, to the extent of 10% of its face ("Coverage") and receive an annual guarantee fee.

②The B-IDGT will pay interest only to Mr. Smith for 8 years at the federal mid-term AFR rate in effect on the date of the sale, with a balloon payment of interest and principal, on the ninth anniversary. Assuming the federal mid-term AFR (i.e. the rate for a promissory note with a term of more than 3 but less than 9 years) is .91 (10/2021). Assuming the value of the interest sold is $10 million for a 25% interest, and assuming a 30% discount for lack of control and lack of marketability, the sale price could be $7 million. The interest on the note payable annually by the B-IDGT to Mr. Smith in years one

through eight would be approximately $63,700. In year 9, the Trust would also pay accrued interest and $7 million in principal to Mr. Smith.

③ The GRAT will be a three-year GRAT and will make annual annuity payments to Mr. Smith on the anniversary of the funding of the GRAT for the next 3 years. Based on the October 2021§7520 rate of 1.0%, the GRAT would pay 34.0% of the initial fair market value of the GRAT assets on the first anniversary, 40.8% on the second anniversary, and 48.9% on the third anniversary. On the third anniversary, the GRAT would terminate and the remainder would be distributed to Mr. Smith's descendants.

*Assuming the mineral partnership appreciates through royalty distributions at 6% annually and makes distributions to the B-IDGT and other partners of 3% each year beginning in year 1, the underlying value of the trust assets at the end of 9 years would be approximately $13 million, and after payoff of the principal and interest on the note in year 9, would have a liquidation value of approximately $6 million. These assets would be outside of Mr. and Mrs. Smith's estates and the estates of their descendants, and any growth on the assets would continue to be excluded for estate tax purposes as well.