2016 SFSP SECTIONS DAY SEMINAR

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BUSINESS SUCCESSION PLANNING

Presented By:
Leon H. Rittenberg III
Jennifer Rigterink

GRANTOR TRUSTS: USES AND ABUSES

Presented By:
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Biography

Leon Rittenberg III is a New Orleans native. He attended the Wharton School of Business of the University of Pennsylvania where he studied economics and graduated ***magna cum laude***. He returned home to attend Tulane University School of Law where he graduated ***magna cum laude*** with a Juris Doctor. Leon was a summer associate at the Internal Revenue Service's Office of Chief Counsel in Washington, D.C. and also served as a law clerk to the Honorable Will Garwood of the U.S. Fifth Circuit Court of Appeal.

Leon joined the firm in 1994 and became a partner in 2000. His practice is focused on serving the needs of small and mid-sized businesses and their owners; including taxation, finance, estate planning, probate, real estate, mergers and acquisitions and related matters. Leon represents the interests of a number of oil service businesses, marine transportation companies and physician groups. He is a Board Certified Tax Specialist and Board Certified Estate Planning & Administration Specialist, as certified by the Louisiana Board of Legal Specialization. He frequently lectures in areas such as taxation, estate planning and maritime transactions. He has been recognized in ***Louisiana Super Lawyer*** (Tax, Estate Planning & Probate and Business/Corporate) and ***Best Lawyers in America*** (Non-Profit/Charities Law and Trusts & Estates) since 2007, and has been recognized by ***New Orleans Magazine*** as one of their "Top Lawyers of New Orleans" for his work in Equipment Finance Law, Mergers & Acquisitions Law and Tax Law. ***New Orleans City Business*** selected him for their Leadership in Law class of 2014, which "identifies and honors 50 outstanding legal professionals whose successes in law and contributions to the community have set the pace for the legal community."

Leon is very active in the New Orleans community, serving on the Boards and Executive Committees of numerous non-profit organizations. He was recently elected to the Louisiana Board of Legal Specialization's Tax Law Advisory Committee. He enjoys spending time with his wife and three children and attending their many soccer and baseball games.

Notable Transactions

BHBM Represents Bollinger in Sale
BHBM Advises Gulfstream Services, Inc. in Sale
BHBM Advises Performance Energy Services in Sale to Quanta Services
BHBM Advises Gulf Offshore Logistics in Sale
BHBM Assists Bee Mar LLC in $243 Million Sale
BHBM Advises Go-Coil in Sale

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PRACTICE AREAS

Commercial & Equipment Finance
Commercial Real Estate
Estate Planning & Successions
General Business
Maritime
Mergers & Acquisitions
Taxation

BAR ADMISSIONS

Louisiana, 1993

U.S. 5th Circuit Court of Appeal, 1993

U.S. Tax Court, 1995

U.S. Supreme Court, 2002

EDUCATION

Tulane University, J.D., 1992, ***magna cum laude***
· Civil Studies Award winner
· ***Tulane Law Review***
· Order of the Coif

University of Pennsylvania, B.S. Economics, 1989, ***magna cum laude***

CERTIFICATIONS

Board Certified ***Estate Planning & Administration*** Specialist, Louisiana Board of Legal Specialization

Board Certified ***Tax*** Specialist, Louisiana Board of Legal Specialization

JENNIFER RIGTERINK

Biography

Jennifer Rigterink was born in Honolulu, Hawaii, but considers herself a New Orleans "native by choice." She received a bachelor's degree in English Literature from the University of Oxford, and also served as the Editor-in-Chief of the *Oxford Student.* After a stint in Austin, Texas, Jennifer moved to New Orleans to attend Tulane University Law School, where she was a member of the *Tulane Law Review.* She spent her second summer clerking for the Office of Chief Counsel for the IRS in Washington, D.C. Upon graduating *summa cum laude* in 2012, Jennifer received the Conrad Meyer III Award for academic leadership, the Robert Friedman award for academic writing, and was designated a member of the *Order of the Coif*.

Jenny joined Baldwin Haspel Burke & Mayer in 2015. Her practice is focused on transactional matters, with an emphasis on business and estate planning. She helps clients achieve their objectives in a tax-efficient manner. Prior to joining the firm, Jenny served as a law clerk to the Honorable Jacques L. Wiener, Jr., Circuit Judge for the United States Court of Appeals for the Fifth Circuit, and to the Honorable Yvette Kane, District Judge for the Middle District of Pennsylvania.

Outside of work, Jenny enjoys gardening, chasing down her dog, Buster, and dancing with the NOLA Cherry Bombs, an all-women dancing and parading troupe founded in 2011.

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PRACTICE AREAS

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Taxation

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Louisiana, 2013

Texas, 2012

EDUCATION

Tulane University Law School, J.D., 2012, *summa cum laude*
· *Tulane Law Review*

University of Oxford, B.A. Honors, English Language & Literature, 2007
· Editor-in-Chief of the *Oxford Student*

BUSINESS SUCCESSION PLANNING

By:
Leon H. Rittenberg III
Jennifer Rigterink

I. INTRODUCTION

A. Background.

A survey conducted by the U.S. Small Business Administration a few years ago indicates that ninety (90%) percent of the 21 million U.S. businesses are family-owned, and that approximately one-third (1/3) of the Fortune 500 are either family-owned or family-controlled. Family-owned businesses create over seventy-five (75%) percent of new jobs and account for about half of our gross national product. However, only approximately thirty (30%) percent of family-run companies today succeed into the second generation, and only about fifteen (15%) percent survive into the third generation.

Furthermore, a recent survey of the Canadian Federation of Independent Business found that approximately one-third (1/3) of independent business owners plan to exit their businesses within the next five years, and almost two-thirds (2/3) plan to exit within the next ten years. However, only about ten (10%) percent have a formal written succession plan, thirty-eight(38%) percent have an unwritten, informal plan, and fifty-two (52%) percent have no plan at all. It is estimated that $1.2 trillion in business assets are poised to be transferred.

In addition to death taxes and other factors, the lack of a business succession plan may be a significant reason for the failure of the family-owned business to continue into future generations.

Business succession planning is a process for facilitating the orderly transition of the ownership and management of a business to new owners and managers in a manner that minimizes the tax cost and maximizes the family's non-tax goals and objectives. In many instances, the family business is a major, dominant and illiquid asset of the business owner's estate and, consequently, the succession of the business often is the primary estate planning goal and concern.

B. The Typical Family-Owned Business.

1. Informality.

2. Concentrated decision making.

3. Talents of family members - a mixed bag.

4. Non-family employees - expectations.

5. Operating and non-operating assets in the same entity.

6. Often not structured in the most tax efficient fashion.

7. Major asset of estate causing death tax exposure.

C. Common Family Business Issues.

1. Management and control.

2. Responsibilities - shared or concentrated.

3. Compensation of family members.

4. Employment opportunities for family.

5. “Entitlements.”

6. Active v. Inactive owners.

7. Capital needs v. family needs.

8. Charting the future - who will be in or out?

9. Role of surviving spouse.

10. Will the business survive to the next generation?

D. Unique opportunity to combine the strengths of the legal and accounting professions.

II. <u>FACT GATHERING</u>

A. Business History.

1. Entrepreneurial origins.

2. Current entity structure and taxation:

a. C Corp.

b. S Corp.

c. Partnership/L.L.C.

3. Product or service.

4. Customer base, geography.

5. Regulatory challenges.

6. Management – family, non-family, mixture.

7. Employees.

8. Competition.

9. Prospects.

10. Ownership vs. Management.

B. Family History.

1. Role of business owner and spouse – independence, ego, desire to maintain control.

2. Children/grandchildren.

a. Active v. inactive.

b. Special challenges - sibling rivalries.

3. Non-family key employees.

4. Role of business as primary source of economic and emotional support of business owner and family.

C. Determination of Net Worth.

1. Review of personal financial statement.

2. Owner's estimate of value of the business – reliable?

3. Life insurance ownership and structure.

D. Decision to retain the business within the family or to sell to third parties.

III. <u>ESTIMATE OF CURRENT EXPOSURE TO ESTATE TAX</u>

A. On January 1, 2013, Congress passed the American Taxpayer Relief Act, ("ATRA") which the President signed into law the following day, providing some degree of planning certainty for the future:

1. The unified credit (indexed for inflation) exemption for estate, gift and generation skipping transfer tax was made permanent. The exemption with inflation index is $5,450,000.00 ($10,900,000.00 for both spouses) in 2016.

2. A 40% transfer tax rate is imposed.

3. Portability between spouses of the unused estate tax exemption was made permanent, provided an estate tax return is filed in the first spouse's estate.

B. Alternative projections based upon differing legislative scenarios.

C. Liquidity analysis.

1. Review of existing life insurance coverage, if any:

a. Policy ownership restructure.

b. Investigation of current insurability, rating, etc.

2. Existence and amounts of other liquid assets, including marketable securities.

D. Applicability of Estate Tax Relief Provisions.

1. IRC Section 6166.

a. The estate tax attributable to the closely-held family business can be deferred for 5 years (interest only) and paid in 10 equal installments if the value of the business exceeds 35% of the adjusted gross estate. Interest is at 2% on the first $1 Million of value of business interest (adjusted for inflation) less the applicable exclusion amount, with interest on the balance at 45% of the normal rate on deficiencies; IRC §6601(j).

b. Active trade or business requirement. A corporate holding company owning, in turn, an entity with an active trade or business will comply.

c. The business must be "closely-held", meaning a sole proprietorship, a partnership with 15 or fewer partners or a corporation with 45 or fewer shareholders.

d. The estate must include at least 20% of the equity ownership of the partnership or corporation.

e. IRS entitled to seek collateral.

2. Bank loan or Graegin loan by the business to the estate as an alternative. See, Estate of Graegin v. Comm'r, 56 T.C.M. 387 (1988).

IV. THE DECISION TO RETAIN WITHIN THE FAMILY

A. Preliminary Planning Techniques.

1. Execution of Wills.

a. Use of exemptions of both spouses.

b. QTIP marital deduction deferral.

(1) Usufruct for life in favor of surviving spouse.

(2) Income interest in trust in favor of surviving spouse for life over marital portion.

c. Testamentary trusts for family protection.

2. Preserve any special status such as Minority Business Enterprise or Women Controlled Business.

B. Restructuring of the Family Business.

1. Tax Free Reorganization.

a. Control. Consider creation of voting and non-voting equity interests in a one to nine ratio to facilitate control through the retention of voting equity, coupled with estate reduction through transfers of non-voting equity interests to the next generations, either directly or through trusts for their benefit. S status will not be hampered by this capital structure since differences in equity limited to voting rights will not create a second class of stock. IRC §1361(b)(1)(D);

1361(c)(4).

b. <u>Corporate Recapitalizations</u>. The recapitalization will be a tax-free E reorganization under IRC §368(a)(1)(E) for both C and S corporations. Partnerships, including LLC's taxed as partnerships, also can be reorganized this way on a tax-free basis.

c. <u>Conversions to LLCs</u>. Corporations can be converted to LLCs, but care must be taken to avoid a technical liquidation for income tax purposes resulting in double taxation of C corporations and single taxation of S corporations by structuring the conversions as tax-free F reorganizations under IRC §368(a)(1)(F).

d. <u>Pass-Through Status</u>. Either "S" status or partnership tax status is desirable for future transfers, particularly if transfer by sale is necessary or appropriate, in order to facilitate the shifting of company cash flow to the next generation.

e. <u>Formation of New Entity</u>. Form a new pass-through entity while allowing the existing entity to "die on the vine."

2. Division of business to accommodate different interests. IRC §355 transactions often are discussed but implemented rarely due to limitations on qualification. In September 2015, the IRS extended its no-ruling policy to include Section 355 spinoffs in which either corporation relies on assets with a value of less than 5% of the corporation's total assets to satisfy the 5-year "active trade or business" requirement of Section 355.

C. Gift Giving and Valuation of Closely-Held Family Businesses.

1. Fair Market Value.

a. <u>In General</u>. "Fair market value" is the applicable standard for federal and state income and transfer tax purposes. As a result, other standards such as "fair value" as used for shareholder dissenter's rights (see, for example, LSA R.S. 12:131(C)(2)) or for purposes of generally accepted accounting principles ("GAAP")(SFAS No. 157) are beyond the scope of this outline.

b. <u>Historical Background</u>. The term "fair market value" first appeared in a federal statute in Section 202(b) of the Revenue Act of 1918 stating that, to determine gain or loss on an exchange of property, the value of the property received would be the cash equivalent of the fair market value. A year later, in 1919, the Advisory Tax Board (predecessor to the Board of Tax Appeals) introduced the concept that the buyer and seller should be under no compulsion and be knowledgeable of all relevant facts. In 1925, the Board of Tax Appeals held that the buyer and seller should be "willing" and that fair market value should be determined on a valuation date without regard to subsequent events. <u>Charles P. Hewes</u>, 2 B.T.A. 1279 (1925). In 1929, the Board of Tax Appeals held that the willing buyer and seller are hypothetical rather than actual persons. <u>National Water Main Cleaning Co. v. U.S.</u>, 16 B.T.A. 223 (1929). In 1936, the U.S. Supreme Court held that, for federal income tax purposes, real estate should be valued at its highest and best use rather than its actual use. <u>St. Joseph Stock Yards Co. v. U.S.</u>, 298 U.S. 38 (1936).

c. <u>Current Treasury Definition</u>. Although today fair market value is referred to hundreds of times in the Internal Revenue Code, it is not defined there. Instead, Congress has left the definition to the Treasury Department:

"… the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts…" Reg. §20.2031-1(b); Reg. §25.2512-1.

d. <u>Revenue Ruling 59-60.</u> In the context of a closely-held entity, Revenue Ruling 59-60, 1959-1 C.B. 237, is the most frequently cited authority and lists the following factors to be considered:

(1) The nature of the business and the history of the enterprise from its inception.

(2) The economic outlook in general and the condition and outlook of the specific industry in particular.

(3) The book value of the stock and the financial condition of the business.

(4) The earning capacity of the company.

(5) The dividend-paying capacity.

(6) Whether or not the enterprise has goodwill or other intangible value.

(7) Sales of the stock and the size of the block of stock to be

valued.

(8) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

Certain factors may carry more weight than others, depending on the circumstances. Rev. Rul. 59-60 cites the following examples:

(1) Primary consideration should be given to earnings if the company sells products or services to the public. However, it acknowledges that appropriate capitalization rates will vary under the circumstances.

(2) Asset values may be given the greatest weight for investment or holding companies, considering also the cost of liquidation.

(3) Rev. Rul. 59-60 specifically prohibits weighted averages of the various factors, often overlooked by experts in litigated cases.

Although public Revenue Rulings generally do not have the force of law, and are viewed as nothing more than a statement of the IRS position on a given matter, Rev. Rul. 59-60 has been cited so often over the years that, for all intents and purposes, it is viewed by practitioners as having that authority.

e. Subsequent Events. Fair market value must be determined as of a particular valuation date (date of gift, date of death or alternate valuation date, for example). Although the definition requires the willing buyer/seller to be knowledgeable of all relevant facts as of that date, subsequent events are generally ignored unless reasonably foreseeable on the valuation date. Campbell v. U.S., 661 F.2d 209 (Ct. Cl. 1981); Saltzman v. Comm'r, 131 F.2d 87 (2d Cir. 1997). Nevertheless, in certain cases, subsequent actual sales are considered as reliable evidence of fair market value if close enough in time to the valuation date, where there are no intervening events that would have an impact on value. First National Bank of Kenosha v. U.S., 763 F.2d 891 (7th Cir. 1985).

2. Methods of Valuation.

There are three basic methods: the market comparison, asset-based and income approaches.

a. The Market Comparison Approach.

(1) Comparable Sales. Since actual sales of the closely-held interest are rarely available, this approach requires the appraiser to locate similar closely-held companies that have been bought and sold, if applicable.

(2) Public Comparables. As an alternative, the appraiser selects comparable or guideline public companies and compares price/earnings, price/dividend, price/book value, etc. ratios and adjusts the result for the particular facts involved such as economic risk, growth expectation, financial structure, size, etc. See, for example, Estate of Hall v. Comm'r, 92 T.C. 312 (1989); Estate of Gallo v. Comm'r, 50 T.C.M. 470 (1985).

(3) Industry Rules of Thumb. If applicable, the appraiser uses accepted rules of thumb for certain industries. For example, accounting practices often sell for prices ranging from 50% to 150% of gross fees as a rule of thumb. See, for example, Desmond, Handbook of Small Business Valuation Formulas and Rules of Thumb, 3d. Ed. (Valuation Press, 1993).

b. The Asset-Based Approach.

(1) Adjusted Book Value Method. All assets and liabilities are valued at fair market value and the net worth is the targeted result. It is suggested that this approach be used for asset intensive businesses such as holding companies, manufacturing and some distribution companies, but not service businesses or distribution companies with few assets. Curiously, the cost of liquidation is considered a "valuation error" although Rev. Rul. 59-60 states this factor "merits consideration" in an asset value approach. The jurisprudence often concurs that the cost of liquidation should not be considered unless a liquidation of the company was planned. Estate of Cruikshank, 9 TC 162 (1947); Ward v. Comm'r, 87 TC 78 (1986); Estate of Piper, 72 TC 1062 (1979); TAM 9150001.

(2) Liquidation Value Method. This approach is suggested where sales would result in a value greater than the adjusted

book value method if the business assets were sold. This approach requires consideration of the cost of liquidation, including taxes, and a discounted present value is used to reflect the time value of money when sales would span an extended period of time. See, for example, Estate of Dunn v. Comm'r, 301 F.3d 339 (5th Cir. 2002).

c. The Income Approach.

(1) Capitalization of Benefits Method. A value is determined by multiplying a past benefit stream to be selected (pre-tax earnings, after-tax earnings, dividends, earnings before interest and taxes, etc.) by a selected capitalization rate reflecting an appropriate rate of return. The benefits stream must first be adjusted to remove non-arm's length items such as excessive compensation, perquisites, etc. and to normalize depreciation. This approach is used when past benefits will continue in the future on a predictable, consistent basis.

(2) Discounted Future Benefits Method. If future benefits are expected to differ from past operating results substantially, a forecast of future expected benefits is made over a number of years which is then discounted to present value.

(3) Excess Earnings Method. This approach tracks Rev. Rul. 68-609, 1968-2 C.B. 327. The net tangible assets are valued and liabilities subtracted at fair market value. To this amount an intangible value is added which is calculated by capitalizing income in excess of an amount which would be a reasonable return on the net tangible asset value. Rev. Rul. 68-609 suggests rates of return on tangible assets from 8 to 10% and capitalization rates of 15 to 20%. The practice guide warns against adhering to these figures too closely since they may not reflect current risk. The higher the risk, the higher the rate of return (as compared to rates on U.S. Treasury Bonds, for example) and the lower the appropriate capitalization rate.

(4) Inputs and Parameters. Although, in theory, the income approach is mathematical and, thus, objective, the selection of the appropriate discount rates, factors and parameters involve subjective determinations about which reasonable experts can, and often, differ. See, for example, Estate of Furman v. Comm'r, 75 T.C.M. 2206 (1998); Brewer Quality

Homes, Inc. v. Comm'r, T.C. Memo 2003; Estate of Klauss v. Comm'r, 79 T.C.M. 2177 (2000); Estate of Hendrickson v. Comm'r, 78 T.C.M. 322 (1999).

3. Discounts and Adjustments.

a. Louisiana Jurisprudence. For many years, the jurisprudence has recognized that a partial or fractional interest is not necessarily valued at a prorata portion of the value of the overall enterprise. For example, the Louisiana Supreme Court in Shopf v. Marina Del Ray Partnership, 549 So. 2d. 833 (La. 1989) took judicial notice that fractional interests "...may be uniquely valuable to the owner, but may have considerably less value to an independent third party because the interest is relatively illiquid and difficult to market...", applying a discount of 33% to a 12% partnership interest. But see, Cannon v. Bertrand, 2 So. 3rd 393 (La. 2009), holding, for state law purposes, no discount for minority interest in a dispute between existing partners. In Shopf, the court appeared to apply fair market value, while in Cannon the court appeared to apply "fair value." See also, Fancher v. Prudhomme, 112 So. 3d 909 (La. Ct. App. 2013) citing Cannon for determining fair market value under LSA R.S. 12:1325(C) for a withdrawing member of a Louisiana L.L.C., applying book value (where withdrawing member was sole source of L.L.C. business customers).

b. In General. In addition to other discounts, there are two major adjustments, namely, for minority interest and lack of marketability status, which are separate and discrete discounts available for transfer tax purposes, although many court opinions lump them together in arriving at an overall aggregate discount.

c. Minority Interest Discount. A minority discount is a reduction in the control value of the interest to reflect the fact that a minority business owner cannot control the policy decisions of an enterprise, including payment of dividends or liquidation. The converse of a minority discount is the control premium, a disproportionate share in value to reflect the control of business decision making, limited only by fiduciary duties to minorities. It is important to remember that listed stock quotations are of marketable minority interests.

(1) Many analysts use statistical data from takeovers of public companies to measure the appropriate size of the discount from the Mergerstat Review.

(2) Experts for both the taxpayers and IRS often have referred to shares of publicly traded, closed end investment funds, which typically trade at a discount relative to their share of the fund's net asset value. The theory is that because those funds are marketable, the discount must be attributable to the lack of control of a minority interest. Since these discounts differ depending upon the fund's type of underlying assets, the jurisprudence has developed a trend of applying different percentage discounts to the net asset values of different asset categories within the same partnership. For example, in McCord v. Commr., 120 T.C. 358 (2003), the Tax Court applied a 10% minority discount to a partnership's equity portfolio, a 10% discount to its bond portfolio, an 18% discount to its real estate partnership portfolio, a 40% discount to its direct real estate holdings and a 33.5% discount to its oil and gas interests, before application of a single, separate discount for minority interest on a partnership-wide basis. In Lappo v. Commr., T.C. Memo 2003 - 258, an 8.5% minority interest discount was applied to a partnership's marketable securities, while a 19% minority discount was applied to its real estate, before applying a single discount for lack of marketability. In Perracchio v. Commr., T.C. Memo 2003 - 280, the Tax Court applied the following different discounts for minority interest to the partnership's asset groupings before applying a discount for lack of marketability: cash (2%), U.S. government bonds (6.9%), state and local bonds (3.5%), municipal bond funds (3.4%), domestic equities (9.6%), and foreign equities (13.8%).

d. Discount for Lack of Marketability. A discount for lack of marketability recognizes the difficulty or impossibility of selling business interests that are not traded on a listed stock exchange. This discount can apply to controlling interests. Estate of Andrews v. Comm'r, 79 T.C. 938 (1982).

(1) It can be measured by reference to SEC restricted stock data, which has been recognized by IRS. Rev. Rul. 77-287, 1977-2 C.B. 319.

(2) This discount is often measured by studies that compare the private market price of shares sold before a company goes public with the public market price of the same stock shortly after an initial public offering. The discount is also reflected

in studies that compare the private market price of restricted shares of public companies that cannot be resold in the public market for a period of time (because the shares have not been registered with the SEC) with the public market price of the same shares without the resale restriction. In this regard, the differences between the taxpayer's experts and those of the IRS vary greatly. Often the taxpayer's experts find discounts in the 35 to 40% range, whereas a particular IRS expert has argued for only a 7% discount. The Tax Court has settled the issue at 20% in McCord, 24% in Lappo and 25% in Perracchio.

e. Sequenced Discounts. Although separate and independent concepts, most authorities consider it appropriate to assess the applicability of the minority discount first and thereafter the discount for lack of marketability. As a result, the total aggregate discounts will not be the arithmetical sum of the two (2) percentage discounts. For example, if each discount is 40%, the total of the two discounts will be 64% of the control value rather than 80%. This is because the second discount for lack of marketability is applied to the control interest already discounted for minority interest. Thus, the second 40% discount is multiplied by only 60% of the control value and reflects only 24% of that control value.

f. Jurisprudence. IRS historically took the position in all jurisprudence that no discounts for minority interest were appropriate and was generally unsuccessful where the taxpayer provided competent appraisals.

(1) The most dramatic defeat for IRS occurred in Estate of Bright v. U.S., 658 F. 2d. 999 (5th Cir. 1981) where the decedent died with an undivided one-half community property interest in shares of stock representing a control block of 55%. The decedent's undivided ½ interest, or 27.5%, was held to be a minority interest qualifying for a discount even though the shares were held by the decedent's surviving spouse as trustee of a testamentary trust. See also, Propstra v. U.S., 68 F. 2d. 1248 (9th Cir. 1982) for a similar result for fractional interests in real estate.

(2) In Estate of Andrews v. Comm'r, 79 TC 938 (1982) and in Estate of Lee v. Comm'r, 69 TC 860 (1978), nonacq., 1980-2 CB 2, the Tax Court flatly ruled that corporate stock owned by other family members could not be attributed to the

decedent for purposes of determining whether the estate owned a controlling or minority interest.

(3) In Rev. Rul. 81-253, 1981-1 CB 187, the IRS reasserted its position regarding unity of ownership among family members for purposes of determining whether an interest is a controlling or a minority interest and indicated its nonacquiescence to Estate of Bright, supra.

(4) On January 26, 1993, IRS ruled in Rev. Rul. 93-12, IRB 1993-7, Page 13, that it will no longer assert the unity of ownership theory to deny minority discounts and revoked its nonacquiescence to Bright and Lee. The facts of the ruling involved a lifetime donation of five blocks of 20% each of the stock of a corporation to five separate donees, each of which were children of the donor. Under the ruling, the donor was permitted to dispose of 100% of the stock but in five transfers of minority interests which, if discounted, would result in value escaping the transfer tax system entirely. Jurisprudence had supported this approach. Rushton v. Comm'r, 498 F.2d 88 (5th Cir. 1974).

g. Other Discounts.

(1) Voting v. Non-Voting. A discount for non-voting equity interests may be available based upon empirical studies of voting versus nonvoting shares in the public stock markets. These studies indicate a range of between 2% and 7% for lack of vote, all other things being equal. See, for example, Barnes v. Comm'r, T.C., Memo 1998-413 (1998); Estate of Winkler v. Comm'r, 57 T.C.M. 373 (1989).

(2) Key Person. In certain cases, the death of a key person has a negative impact on the value of the company equity interest transferred, and, consequently, a discount is appropriate. Estate of Mitchell v. Comm'r, 250 F. 3d 696 (9th Cir. 2001); Estate of Huntsman v. Comm'r, 66 T.C. 861 (1976).

(3) Portfolio Discount. A discount may be available for an asset based approach for "non-homogeneous" assets. Estate of Maxey v. Comm'r, 28 T.C.M. 783 (1969). But see, Knight v. Comm'r, 115 T.C. 506 (2000) where a family limited partnership holding real estate and marketable securities was denied such a discount.

(4) Trapped-In Capital Gains. A discount for the capital gains tax on liquidation of assets in an asset approach valuation may be applicable. See, Estate of Dunn v. Comm'r, supra.

(5) Tax Effecting S Corporations. If S corporation stock is acquired by a willing buyer which is not an eligible S shareholder, the S election would be lost and corporate level tax would be imposed. Alternatively, the universe of willing buyers of S corporation stock may be more limited than the willing buyers of the other equity interests. Nevertheless, the jurisprudence has been reluctant to recognize discounts for this to date. Gross v. Comm'r, 78 T.C. M. 201 (1999); Dallas v. Comm'r, T.C. Memo 2006-212.

h. The Future of Discounts. On April 10, 2013, the Obama Administration in its 2014 Budget "Greenbook" eliminated its former proposal to make valuation discounts an additional IRC §2704 "applicable restriction" to be ignored for federal transfer tax purposes without explanation.

D. Installment Sales to Grantor Trusts.

1. In General.

a. Once the lifetime gift tax exemption is fully depleted, further transfers in excess of annual gift tax exclusion amounts must be made by sales to younger generations.

b. Additionally, many closely-held business owners wish to retain the income from donated interests, but can not achieve estate reduction as a result of IRC §2036(a)(1).

c. Furthermore, a capital gains tax may be unattractive, even if reportable under the installment method of IRC §453.

d. An installment sale of a business interest, such as non-voting equity interests, to an intentional grantor trust ("IDGT") can achieve an estate freeze at discounted transfer tax values, with no income tax recognition, while maintaining positive cash flow in the business owner attributable to the transferred interest without violating IRC §2036.

2. Intentional Grantor Trusts.

a. These trusts are recognized for all legal purposes (other than federal and estate income tax reporting purposes), including transfer tax purposes. The trust is intentionally drafted to violate the grantor trust income tax rules of IRC §§671-678 so that the grantor, rather than the trust or its beneficiaries, is recognized as the "owner" of the trust assets and, consequently, the grantor is the proper income tax payor on the trust's net income.

b. The grantor's power over trust assets to create grantor trust status for federal income tax purposes must not also cause the return of the trust's assets to the grantor's gross estate for federal estate tax purposes under IRC §§2036-2041.

c. Although more than one such power can work, the most popular approach to creating grantor trust status is a non-fiduciary power in the grantor to substitute assets of equivalent fair market value for trust assets under IRC §675(4)(C), without the approval of any person in a fiduciary capacity. IRS has approved this approach and has ruled that it will not cause adverse estate tax consequences, as long as the power of substitution of assets does not cause any shifting of benefits among the trust's beneficiaries. Rev. Rul. 2008-22, 2008-16 I.R.B. 796 (April 21, 2008). See also, Estate of Jordahl v. Comm'r, 65 T.C. 92 (1975), acq. 1977-2 C.B.1.

d. A wholly grantor trust is a permissible S equity owner. IRC §1361(c)(2)(A)(i).

3. Sale structure.

a. In order to avoid or to defend against an IRS argument that the transaction is a gift with retained income under IRC §2036(a)(1), it is generally recommended that the IDGT be "seeded" with donations of business interests of from 10 to 15% of its total assets (including the interests to be sold on an installment basis). There is no case or ruling requiring this, but the requirement appears to be one of good sense, based upon thin capitalization principles. The 10% minimum may have its origins in private letter rulings dealing with IRC §2702. See, PLR 9535026 (Sept. 1, 1995) and PLR 9515039 (April 14, 1995).

b. The installment note should not have a term beyond the life expectancy of the grantor, by analogy to a similar limitation on private annuities.

c. The installment note should carry interest, at least at the applicable federal rate set in IRC §1274(d). An amortizing note rate than interest only is preferable.

d. The note should be secured by a pledge or security interest in the business interest sold and, perhaps, the donated seed business interest as well.

4. Tax Schizophrenia.

a. Although the donated and sold business interests are removed from the business owner/grantor's gross estate for federal estate tax purposes, the IDGT is ignored for federal and state income tax purposes.

b. Thus, the donated and sold business interests are still considered as "owned" by the grantor for income tax reporting purposes. The grantor must report on the partnership or S corporation K-1 the income attributable to these transferred interests. The income tax liability is the grantor's, and the payment of the income tax is not an additional gift to the trust beneficiaries. Rev. Rul. 2004-64, IRB 2004-27. Estate reduction through continuing payment of the income tax liability from other assets is a major estate planning benefit, particularly for relatively young clients. Care should be exercised if the IDGT instrument gives the trustee discretion to reimburse the grantor for the income tax since IRS may find an implied agreement to so reimburse, thereby triggering estate inclusion of trust assets under IRC § 2036. See, Rev. Rul. 2004-64, supra.

c. The installment sale is ignored for income tax purposes. There is no gain or loss realized by the grantor, and the interest element of the installment note is neither gross income to the grantor nor deductible by either the trust or its beneficiaries.

d. As a result, the transferred business interests must generate sufficient income and cash flow to:

(1) Service the debt; and

(2) Cover the grantor's income tax liability from the transferred business interests.

The CPA's pro-forma projections are thus critical in determining the amount of interest that can be sold and financed through this process.

e. The fact that the non-marketable, minority and, perhaps, non-voting interest donated and sold is subject to transfer tax valuation discounts permits substantial leveraging of the installment note, particularly in the low interest rate environment currently prevailing in our economy.

f. The current $5.45 Million gift tax lifetime exemption (prior to cost of living increases), leveraged with transfer tax discounting, will permit installment sales of substantial value.

g. Assume that the $5 Million of business interest subject to a combined 35% discount for lack of marketability and for minority interest status, which equates to $7,692,308 before discounts. To maintain a 10% debt to equity ratio, a seed gift of $7,692,308 (fully protected by the $5.45 Million gift tax exemption) could support an installment sale of $69,231,672:

$ 7,692,308	seed gift
69,231,672	installment sale
$76,923,980	total business interest transferred

h. The income generated by the transferred interests, both donated and sold, is the undiscounted, pro-rata portion. However, the underlying interests were transferred, both by donation and installment sale, at a 35% discount. Thus, there is a financing leverage of approximately 153.8%. [100% ÷ (1-35%)].

i. The January, 2016 long-term applicable federal rate, compounded annually, is 2.65%. If total growth can outstrip that rate, the excess will escape transfer tax for transactions occurring in January, 2016.

E. Shareholder/Operating Agreements to set guidelines for future family ownership.

1. An approach gaining popularity is to set standards and guidelines for equity ownership by younger generations in a shareholder agreement or operating agreement, thereby limiting *inter vivos* donations and bequests.

2. Minimum age, education, etc.

3. Work experience at another unrelated company for a minimum number of years.

4. Satisfaction of requirements by younger generation (or spouse, in the

alternative).

5. Enforcement through options, puts and calls.

F. Providing New Business Opportunities to the Next Generation.

1. Allowing existing family business to "die on the vine." Liquidation of C corporations may be required to avoid personal holding company status.

2. New business entity formed to exploit the new opportunities, with next generation the holders of growth equity.

3. Older generation provides or facilitates financing, thereby effectuating an estate freeze.

V. <u>THE DECISION TO SELL OUTSIDE OF THE FAMILY</u>

A. In General.

1. By definition, a closely-held family business is an asset with no market.

2. Going Public - probably not a viable option for most.

3. Private equity funds.

4. Investment bankers or business brokers may be able to find a buyer, but chances are the price may be distressed. The only interested buyer may be a competitor, for example.

5. Key non-family personnel or non-family co-owners are possible purchasers. The transaction normally involves a transfer of a relatively small interest in the business to one or more key employees who are non-family members, subject to a buy-sell agreement.

B. Buy-Sell Agreements.

1. There are three (3) basic types of buy-sell agreements.

a. Entity Redemption Agreement. This is an agreement where the business enterprise agrees to buy (redeem) the business interest from the selling party.

b. Cross-Purchase Agreement. This is an agreement solely among owners who agree to buy each other's interests.

c. Combination Agreement. This is an agreement when the business and its owners agree jointly or in the alternative to buy the seller's interest.

There are variations on each, such as "option" buy-sell agreements. The right to buy or sell may be given to one or both parties (put or call rights).

2. The price paid under a buy-sell agreement may be all cash, or may be on an installment basis.

3. Life Insurance Funding of Entity Redemptions.

a. Structure.

(1) The business entity is the applicant, owner and beneficiary of a policy insuring the life of the business owner whose interest will be purchased.

(2) The business entity is the premium payor.

(3) Premiums are not deductible.

b. Effects of life insurance funding.

(1) Insurance proceeds are income tax-free to partnerships, limited liability companies and "S" corporations, but not necessarily to "C" corporations.

(2) Surviving owners own 100% of entity.

(3) "C" corporation basis does not change for the remaining stockholders.

(4) For "S" corporation stockholders, basis increases by the amount of death proceeds received by the corporation in proportion to their interests.

(5) Basis does not change for surviving partners in a partnership, unless the partners elect under I.R.C. § 754.

(6) The selling business owner's estate obtains a stepped up basis

at death. If the buy-sell price is at fair market value, no gain or loss is reported. Business value is included in selling owner's estate.

c. Corporate stock redemption tax traps for "C" corporations.

(1) The cash value increases and the death proceeds received by a "C" corporation may be subject to the corporate alternative minimum tax. 75% of adjusted current earnings in excess of the base alternative minimum taxable income is an adjustment in arriving at alternative minimum taxable income for "C" corporations. IRC §56(g)(1)(A). Adjusted current earnings include life insurance proceeds to the extent they exceed the corporation's adjusted basis in the contract. Reg. §1.56(g)-1(c)(5)(v). Therefore, the proceeds may be taxed at an effective rate of 15%, since the AMT rate is 20% for "C" corporations (75% x 20% = 15%). IRC §55(b)(1)(B)(I). This alone should not be the reason for rejecting corporate owned life insurance as a means of funding a stock redemption. The impact of the AMT can only be determined each year when all the facts are known, and it may be that no additional tax is due.

(2) Redemption payments to a "C" corporation shareholder can be taxable as ordinary dividend income, subject to the dividends received deduction. IRC §243.

i. Capital gain treatment is available if one (1) of four (4) conditions are met:

(a) If the redemption is not essentially equivalent to a dividend. IRC §302(b)(1).

ii. If the distribution is substantially disproportionate with respect to the shareholder. IRC §302(b)(2).

iii. If the redemption is a complete termination of interest. IRC §302(b)(3). A complete termination of interest requires a shareholder to sell all of the stock of the corporation and give up any management duties and directorships. IRC §302(c)(2)(A).

(a) Stock attribution rules of IRC §318 make substantially disproportionate and complete terminations difficult to accomplish.

(b) A shareholder is deemed to constructively own stock owned by related parties as follows:

(i) Stock owned by a spouse, parents, children, and grandchildren, or stock constructively owned by them. There is no attribution among siblings. IRC §318(a)(1)(A).

(ii) A shareholder owning 50% or more in value of a corporation is deemed to own proportionately the stock owned by the corporation. In turn, stock owned by a 50% or more shareholder is attributable to the corporation. IRC §318(a)(2)(C).

(iii) Stock owned by a partnership is attributed proportionately to its partners. Stock owned by partners is attributed to the partnership. IRC §318(a)(2) and (a)(3).

(iv) Stock owned by an estate is attributable to the beneficiaries of the estate. Stock owned by the beneficiaries of an estate is attributable to the estate. IRC §318(a)(2) and (a)(3).

(v) Stock owned by a trust is attributed to its beneficiaries in proportion to their actuarial interests. Stock owned by beneficiaries of a trust (more than a 5% interest) is attributable to the trust. IRC §318(a)(2)(B) and (a)(3)(B).

d. Family attribution rules may be waived for complete terminations under IRC §302(c)(2)(A) if:

(1) Immediately after the redemption, the shareholder whose

shares are redeemed has no ownership interest in the corporation and no interest as an officer, director or employee. Creditor and independent contractor relationships may be permitted.

(2) No interest is reacquired within 10 years after redemption except by gift or inheritance, by the redeemed shareholder.

(3) The redeeming shareholder files a timely agreement with the I.R.S. to this effect.

i. Waiver of attribution is difficult to accomplish in the family business context where shareholders include parents and children. For example, if a father leaves property to his daughter and stock to his wife, subject to a buy-sell agreement, the fact that the daughter is a beneficiary precludes a waiver of attribution.

e. Capital gain can be achieved under IRC §303 if the redemption is required in order for the decedent's estate to pay death taxes, subject to the following restrictions:

(1) The stock redeemed must be included in the decedent's estate.

(2) Only an amount up to the amount of estate taxes and funeral and administration expenses can be redeemed.

(3) The value of the decedent's stock of the redeeming corporation must exceed 35% of the decedent's adjusted gross estate.

(4) IRC § 2035 (c)(1)(A) will include in the gross estate for the purpose of the § 303 redemption any gifts of stock made within the last three (3) years prior to death.

4. A "C" corporation could be exposed to the accumulated earnings tax if it accumulates liquid assets to fund a buy-sell agreement, although there is jurisprudence which has held that such accumulations can be for the reasonable needs of the business. Dickman Lumber Co. v. Commissioner, 355 F.2d 670 (9th Cir. 1966); Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir. 1958); But see, Mountain States Steel Foundries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960); and Ted Bates & Co., Inc., 24 T.M.C. 1345 (1965).

a. Advantages of Stock Redemption Agreement.

(1) Simplicity.

(2) The business pays the life insurance premiums. For "C" corporations, one benefit is that the premiums are paid with money that has been taxed only to the business, and not taxed to the shareholders (as dividends). For all entities, the owners have greater control over ensuring premiums are timely paid.

(3) The business owns the cash values of the policies, which means they can not be reduced by loans by the individual owners. Consider whether the business should be prohibited from accessing the cash values prior to its redemption obligation.

b. Disadvantages of Stock Redemption Agreement.

(1) All surviving owners' percentages of ownership are equally affected, which may cause the relative percentages of ownership to change. Unintended shifts in control may occur.

(2) When the surviving owners of a "C" corporation later sell stock, they may realize higher gains since their basis in stock does not increase.

(3) In an "S" corporation there is some increase in tax basis of the surviving shareholders. The tax-free proceeds increase each shareholder's basis in proportion to their ownership shares. This increase is wasted to the extent it is allocated to the basis of the decedent's stock.

(4) It is difficult to convert from a redemption to a cross-purchase arrangement funded by life insurance without violating the transfer-for-value rule of IRC §101(a)(2).

(5) If the business is a family owned corporation, attribution may cause the funds received in a redemption to be treated as dividends to the decedent's estate.

(6) If the business is a "C" corporation, the corporate alternative minimum tax may cause the cash value increases and the death proceeds to be taxed.

(7) The proceeds may be included in the value of the business for death tax purposes.

5. Life Insurance Funding of Cross-Purchase Agreement.

a. Structure

(1) Each co-owner is the owner and beneficiary of policies on the other owners' lives not on their own lives. The policy proceeds are used to purchase the business or investment interest.

(2) <u>Tax Trap</u>: The owner of the policy cannot name the insured co-owner who is to be bought out as the beneficiary because the death benefit could be taxable to the beneficiary under the transfer-for-value rule.

(3) <u>Tax Trap</u>: If the business is a partnership, the business should not pay the premiums and name the surviving spouse as the policy beneficiary because a surviving partner will not obtain an increase in cost basis equal to the death proceeds.

(4) Premiums paid are not deductible.

b. Effects.

(1) Death benefit proceeds pass tax-free to the surviving owners.

(2) A survivor's tax basis in his business interest increases to the extent of the interest which is purchased.

c. <u>Problem</u>: What does the estate of the first owner to die do with policies on the other co-owners? The transfer may be a taxable transfer for value.

(1) The sale of the policies from the estate to other shareholders will be a transfer for value if the business is a corporation, unless:

i. The policies are sold to the corporation, or

ii. Each survivor purchases the policy on his or her own life from the estate, or

iii. The policy is surrendered for cash.

(2) Solution: Give surviving insureds the right to purchase policies on their lives from estate of first owner to die.

d. In structuring cross-purchase agreements, survivorship clauses are recommended which limit the parties obligations if multiple deaths occur in a short time period.

C. Cross-Purchase Advantages.

1. Cash values of the policies are not seizable by creditors.

2. It is easier to convert a cross-purchase plan into a stock redemption plan than vice versa because of the transfer-for-value rule.

3. The attribution rules of I.R.C. § 318 do not apply.

4. The corporate alternative minimum tax is not applicable.

5. The survivors receive a tax basis in their purchased business or investment interest equal to the amount paid. However, amounts paid for unrealized receivables, substantially appreciated inventory and goodwill in a sole proprietorship or partnership do not increase basis.

D. Disadvantages of the Cross-Purchase.

1. If there is a disparity in the ownership share, age or risk classification of the owners, the premium burden may be perceived to be inequitable. For example, a younger, minority owner will have a greater premium burden than an older, majority owner.

2. Non-payment of premiums might not be disclosed to the party who is to be bought out so there is less security knowing that the other owners are responsible for paying the premium on his or her life.

3. If there is a large number of owners, administration of the policies may become cumbersome.

4. Each remaining owner must adjust the insurance if a new owner is admitted or an existing owner departs to compensate for this change.

5. In a corporate setting, transfer-for-value problems may result upon the disposition of the policies owned by the deceased shareholder on the lives of

the remaining shareholders.

6. There may be a lost opportunity to leverage the premium payment if the business is a regular "C" corporation. It may be more expensive to pay premiums with the personal after-tax incomes of the shareholders.

7. Cash values of the policies may be accessed by the owners personally. This may negatively affect the buy-sell funding and may not be disclosed to the party who is to be bought out.

E. Variation on Cross Purchase[1].

1. One variation of a cross-purchase agreement is an escrowed or trusted buy-sell agreement which works well in the partnership context.

   a. The business owners agree to buy and sell their respective business interests under a cross-purchase agreement.

   b. The business owners also agree (under either an independent agreement or as part of the cross-purchase agreement) to appoint an administrator ("escrowee") to perform the centralized function of overseeing and performing any buy-sell duties on behalf of the business owners.

   c. Only one (1) life insurance policy is purchased for each insured.

2. Life insurance funding of the escrowed buy-sell.

   a. The escrowee:

      (1) holds and is the beneficiary of one policy per insured, and

      (2) credits each business owner with a pro rata interest in the policies covering the others.

   To avoid estate inclusion of the death proceeds in an insured's estate under I.R.C. § 2042, it is critical the agreement specify unequivocally that an insured will not be credited with any ownership interest in a policy insuring his or her life.

   b. Each business owner is responsible for paying the proportionate share

[1]Might be replaced by new insurance products insuring multiple lives and paying at first death.

of the premium owed on each other business owner's life. The escrowee may or may not be involved in the payment of the premiums.

c. At the death of a business owner, the escrowee:

(1) receives the proceeds and delivers them to the estate of the decedent in exchange for the business interest,

(2) credits each surviving business owner's account with the appropriate pro rata ownership of the purchased interest, and

(3) reallocates to the survivors the decedent's escrowed interest in the policies insuring the survivors.

d. Hidden trap of escrowed buy-sell.

(1) The transfer for value rules may be inadvertently triggered.

i. Even if the trustee is the initial owner of the policies, upon the first death, the beneficial or contractual interest of the decedent in the policies on the co-owner's lives automatically shifts to the survivors. This amounts to a transfer-for-value even though there has been no physical transfer or change in the legal title of the policies.

ii. Consider using a partnership rather than a trust as the escrow vehicle. Additionally, if the shareholders are also partners in another business venture, an exception to the rule will be met and there will be no negative income tax consequences. There is no requirement in the statute or accompanying regulations that the partnership or the furtherance of its business be involved in the transfer of policy interest for the partner exception to apply. See PLR 9309021; <u>but</u> <u>see</u> <u>Swanson v. Commissioner</u>, T.C.M, 1974-61, aff'd, 518 F.2d 59 (8th Cir. 1975).

e. Recommend an escrowed buy-sell where:

(1) There are many (more than five) owners of the business who want to participate.

(2) The business is a partnership.

(3) Centralized management and funding beyond the death of the first owner to die.

3. Buy-Sell Pricing Formulas

a. Fixed Price: Under this method, the parties agree to an initial price expressed as a fixed dollar amount which may be reviewed and adjusted by the parties periodically.

(1) Does the agreement provide for periodic reevaluation?

(2) If so, have periodic valuations been made?

(3) Does the agreement provide for the consequences of a failure to revalue?

(4) Is there an alternate valuation method if periodic valuation is not made either because of inattention, inability to agree, or by design.

(5) If the fixed value is made on a per share basis, does the agreement cover the possibility of adjustments in the number of outstanding shares (for example, stock splits, stock dividends or recapitalizations)?

(6) If there is more than one class of stock, does the agreement allocate the fixed price among the classes?

b. Book Value: Although the use of the term "book value" is susceptible to misunderstandings and ambiguities, it generally means the value as reflected on the books and records of the company. Succession of Jurisich, 69 So.2d 361 (La. 1953). <u>See</u>, <u>also</u>, <u>Aycock v. Allied Enterprises, Inc.</u>, 517 So. 2d 303 (La. App. 1st Cir. 1987) for the meaning of "generally acceptable business and accounting principles."

(1) But which books and records?

(2) Balance sheet (audited or unaudited).

(3) Profit and loss statement.

(4) Tax return.

(5) Ledgers.

(6) Monthly statements.

c. Is book value to be determined on a cash or accrual basis?

d. Who determines book value?

e. Does book value reflect real value?

(1) Intangibles (goodwill, tradename, etc.).

(2) Depreciable assets.

(3) Unbilled amounts for services.

(4) Contingent liabilities.

(5) LIFO v. FIFO.

(6) Traded securities held as investment.

f. Does the agreement specify the date on which book value will be determined?

4. Adjusted Book Value: Have all appropriate adjustments been taken into consideration?

5. Appraised Value.

a. Does the agreement specify the date the valuation is to be made?

b. Who determines the value? If an appraiser, how is the appraiser selected? If both sides are to select an appraiser, what if they can't agree on the selection? Does the agreement require that the appraiser have experience in valuing the particular type of business of the clients?

6. Are there guidelines or procedures set forth for the appraiser in valuing specific properties.

a. Real estate - book value or fair market value? If fair market value, which method (replacement cost, income approach, comparables)?

b. Inventories - cost, market, lower of cost or market?

c. Goodwill.

7. Is debt considered?

8. Should the interest being valued be subject to any premium for control or discount for minority interest and lack of marketability? An agreement may fix the estate tax value if negotiated at arm's length, even though control premiums are not considered in valuing the stock of a majority shareholder, if it fixes the price for all shareholders. Rudolph v. U.S., 93-1 USTC par. 60, 130 (1993).

9. Does the agreement specify that the appraisal is binding on all parties?

10. Should the agreement provide a minimum purchase price below which appraised value will not be considered?

11. What effect, if any, will be given to life insurance payable to the company?

12. Who pays for the appraisal and in what proportions?

F. Capitalization of Earnings.

1. Does the agreement define "earnings"? Should adjustments be made to take into account excessive compensation, executive "perks" and discretionary retirement plan contributions?

2. Who determines earnings?

3. Are historical or average earnings considered? If so, are the years to be weighted or is a straight average to be used?

4. Should any adjustment be made for extraordinary gains or losses?

5. Has an appropriate capitalization rate been selected?

H. Estate Tax Value.

1. Does not provide any certainty to the owners until one of them dies or until the estate tax return is accepted by the IRS.

a. What if no federal estate tax return is required to be filed?

b. What if the initial value on the estate tax return is adjusted after audit? If the price is to be determined on the basis of the value as finally determined for estate tax purposes (i.e., after "audit"), what if the return is not audited? Will the parties have to wait until the statute of limitations for audit has run?

2. May give the estate an incentive to select a high value or, upon audit, to agree to a higher value since any additional estate tax will be less than the increased purchase price. Where marital deduction planning is used, it may make no difference to an estate to set a very high value.

I. Other Pricing Formulas.

1. Liquidation value.

2. Combination of methods.

3. "Financials in accordance with generally accepted accounting and business principles."

J. Using the Buy-Sell to Fix the Value for Estate Tax Purposes.

1. A protracted controversy with the IRS over the value of an interest in a closely-held business can be avoided if a buy-sell agreement fixes the value for estate tax purposes.

2. The Treasury's position is that the provisions of a buy-sell agreement are just one factor to be considered in valuing a closely-held interest, depending upon the circumstances of the particular case. Treas. Reg. §§20.2031-3 and 20.2031-2(h); Rev. Rul. 59-60.

3. Despite the Treasury's position, the courts have acknowledged that a buy-sell can indeed fix the estate tax value, even if such value is lower than it otherwise would have been in the absence of no agreement, if certain basic requirements are met. These judicially created requirements are:

a. The agreement must be valid and enforceable.

(1) Was a valid agreement in effect at death?

(2). Was there consideration as required under state law?

(3) Has the agreement been abandoned?

(4) Is the agreement specifically enforceable?

(5) Was the agreement subject to change by the decedent?

b. It must be a bona fide business arrangement. Courts often recognize that insuring family ownership and control is a valid business purpose and end the analysis at that point. See GCM 37958.

c. It must not be a device to transfer property to the natural objects of a person's bounty for less than adequate consideration. Business purpose and lack of a device are separate requirements and both must be satisfied. Estate of Gloekner v. Commissioner, 152 F. 3d 208 (2nd Cir. 1998).

d. The price set in the agreement must be fixed or determinable and must be reasonable when the agreement was made.

e. It must restrict transfers (including gifts) during life as well as at death.

f. The owner's estate must be compelled at death to sell at the price set in the agreement either under a mandatory requirement to sell and buy, or, if optional, at the buyer's option, not the option of the selling estate.

See, e.g., Elvie Cobb, 49 T.C.M. 1364 (1985); Estate of Lauder v. Commissioner, T.C. Memo 1992-736.

4. Section 2703.

a. The Revenue Reconciliation Act of 1990 created new Sec. 2703 as part of the valuation provisions of Chapter 14. Sec. 2703 codifies much of the prior jurisprudence and creates additional requirements for arrangements to fix federal estate tax values. Arrangements subject to Sec. 2703 may be contained in private buy-sell agreements, corporate articles or by-laws or even may be implicit in the capital structure of the entity. Treas. Reg. §25.2703-1(a)(3). However, in the family limited partnership/family L.L.C. arena, the "property" subject to Sec. 2703 is the partnership or L.L.C. interest, not the underlying assets. See, for example, Church v. U.S., 2000-1 USTC par. 60, 369 (W.D. Tex. 2000); Estate of Strangi v. Commissioner, 295 F 3d. 279 (5th Cir. 2002), affirming the Tax Court on the Sec. 2703 issue, but remanding on the Sec. 2036 issue which ultimately was resolved in favor of IRS under the facts of the case.

5. Sec. 2703 divides all buy-sell arrangements into "old" arrangements and "new" arrangements.

   a. Old arrangements are those created before October 9, 1990, which are not substantially modified thereafter. These arrangements are grandfathered and are subject to the rules established under prior jurisprudence rather than Sec. 2703.

   b. New arrangements are those created or substantially modified on or after October 9, 1990. These are subject to Sec. 2703.

6. Sec. 2703(a) provides a general rule of non-recognition of buy-sell arrangements for transfer tax purposes, that is, the value of any property is to be determined without regard to "any restriction on the right to sell or use such property."

7. Sec. 2703(b), however, provides an exception to the general rule, if the buy-sell arrangement satisfies the following three (3) separate and independent tests.

   a. It is a bona fide business arrangement;

   b. It is not a device to transfer property to members of the decedent's family for less than adequate consideration; and

   c. Its terms are comparable to similar arrangements entered into in arm's length transactions. Although this third requirement is new, pre-IRC §2703 jurisprudence examined this criteria as well. Estate of True v. Commissioner; T.C. Memo 2001-167, aff'd, 390 F.3d 1210 (10th Cir. 2004).

8. Treasury Regulations expand the second and third requirements.

   a. Instead of a device to transfer property to decedent's "family members", the Regulations refer to the "natural objects of the transferor's bounty." Treas. Reg. Secs. 25.2703-1(b)(1)(ii) and 25.2703-1(b)(3).

   b. The Regulations state that the "comparability" requirement must be met "at the time the right or restriction is created" and they further provide:

      (1) The comparability requirement applies only if the arrangement is predominantly among natural objects of the

bounty.

(2) If actual comparable arrangements can be found, the comparability requirement will be met. Later, unforeseen events will not prevent the agreement from fixing the estate tax value if comparability is satisfied at the time the agreement is entered into. Estate of Amlie v. Commissioner, T.C. Memo 2006-76.

(3) If no actual comparables are available, the Regulations introduce a new "fair bargain" test, that is, whether the right or restriction is one that could have been obtained in a fair bargain among unrelated parties in the same business dealing with each other at arm's length. Treas. Reg. §25.2703-1(b)(4)(I). To be comparable, an agreement must conform with the general business practice of unrelated parties under negotiated agreements in the same business, considering such factors as:

i. The expected term of the agreement;

ii. The current fair market value of the property;

iii. The anticipated changes in value during the term of the arrangement; and

iv. The adequacy of any consideration given in exchange for the rights granted.

(4) Apparently these factors are not intended to be an exclusive listing and the Regulations are unclear what weight each of these factors has but, as to taxpayer's burden of proof, they provide:

i. Isolated comparables are not sufficient;

ii. If two or more valuation methods are commonly used in a business, only one of the methods need be selected;

iii. It is unnecessary that the terms of a buy-sell agreement parallel the terms of any particular agreement; and

iv. If the business is unique and comparables are difficult to find, comparables from similar businesses may be used. But see, Estate of Hall, 92 TC 312 (1989).

(5) Non-family member exception. The Regulations state that all three requirements of Section 2703(b) will be deemed satisfied if individuals who are not members of the transferor's family, directly or indirectly, own more than 50% of the value of the business interest subject to the restriction, so long as the interest owned by non-family members are subject to the same restrictions as those imposed on the family. Treas. Reg. Sec. 25.2703-1(b)(3).

i. "Family" is very broadly defined to include the transferor's spouse, ancestors of the transferor or his spouse, the spouse of any such ancestor, any lineal descendant of the transferor or the transferor's spouse, the spouse of any such lineal descendant and "any other individual who is the natural object of the transferor's bounty" (even though not related by blood, adoption or marriage).

ii. What if two unrelated persons each owning 50% enter into a buy-sell?

iii. What if one person who owns more than 50% and two or more unrelated persons own the rest enter into a buy-sell?

(6) Substantial Modifications. Sec. 2703 applies to old buy-sell arrangements if "substantially modified" after October 8, 1990. Treas. Reg. §25.2703-1(c).

i. A substantial modification will be any discretionary change, whether or not authorized by the agreement, that results in more than a de minimis change in the quality, value or timing of the rights of any party. See Ltr. Rul. 9322035 (change in terms of deferred payment provisions from 10 to 15 years and interest rate from 10% to 2% above prime not a substantial modification). Also, see Ltr. Rul. 200103038 (change to charter to effectuate a recapitalization of an S corporation to create voting and non-voting stock is not a substantial modification); Ltr. Rul. 200122021 (modifications to update corporate documents which change no rights of existing shareholders are merely administrative in nature and are not substantial modifications).

ii. If the agreement calls for periodic updates including changes of pricing formulas, <u>the failure to update is presumed to create a substantial modification</u> unless the parties can show that such update would have created no substantial modification.

iii. The addition of any family member as a party to the agreement (including by reason of a transfer of property that subjects the transferee family member to the restrictions) is considered a substantial modification unless the addition is mandatory under the terms of the restriction or the added family member is assigned to a generation no lower than the lowest generation occupied by individuals already parties to the agreement. <u>See</u> Ltr. Rul. 9324018.

iv. The transfer of stock subject to an agreement to younger generation family members who will not be subject to the agreement will be a substantial modification of the agreement with regard to the shares retained by the transferor. <u>See</u> Ltr. Rul. 9620017.

v. The following will not be considered substantial:

(a) A modification required by the terms of the agreement;

(b) A change in the agreement to reflect a corporate name change, change of address or registered agent;

(c) A modification of the capitalization rate if the rate is modified in a manner that bears a fixed relationship to a specified market interest rate; and

(d) A modification that results in an option price that more closely approximates fair market value (apparently in the opinion of IRS).

(e) Should grandfathered agreements be modified?

vi. The best rule may be not to touch a grandfathered agreement without a compelling reason to do so. A change that moves the price closer to the fair market value will not be considered a substantial modification.

(a) However, if the parties to the agreement are family members (including siblings, aunts, uncles, nieces, etc.) or who may be the natural objects of each other's bounty, modification will trigger the "fair bargain" test.

vii. What are the lessons to be learned from jurisprudence and Sec. 2703?

(a) Non-Family Members. The purchase price established in a non-family controlled business should fix value for estate tax purposes since it is unlikely that the price would be an attempted device to transfer the business to the natural objects of the transferor's bounty for inadequate consideration.

(i) Under the Regulations to Sec. 2703, it appears that where more than 50% of the interests are owned by non-family members, the estate may not have to show bona fide business purpose, that the transfer was not a testamentary device, or comparability to similar businesses, provided the interests of the non-family members are subject to the same restrictions as family members.

(ii) Until the Regulations are clarified, 50-50 unrelated owners who want to use a formula or any price other than appraised fair market value at death or other triggering events should consider obtaining an expert opinion from an independent qualified appraiser that the price or formula used in the agreement meets the comparability test as of the date of the agreement or, alternatively, there should be documentation of the arms-length negotiations and the reasons for selecting the pricing formula (e.g., separate counsel for the parties, correspondence from counsel and the parties and their accountants, any contemporary evidence such as trade journals or trade associations that the terms of the agreement fall within general business practice for the particular industry).

(b) Family Members. In order to fix value for federal estate tax purposes, the three requirements of Sec. 2703 will have to be met. The third requirement states that at the time the right or restriction is created, the terms of the right or restriction must be comparable to similar arrangements entered into by persons in an arms-length transaction. Absent actual comparables, the "fair bargain" test will be applied. Therefore, it becomes imperative to obtain a professional business appraisal at or near the time the agreement is adopted. If there is no evidence that an attempt was made to arrive at a formula based upon objective standards, the buy-sell may not be effective for establishing value for federal estate tax purposes. Even if the formula is reasonable at the time the agreement is executed, in the family context the Regulations indicate that if it is anticipated that the value of the business will change significantly during the term of the agreement, then reasonableness of the formula or price at the time the agreement is executed may not be sufficient to fix estate tax values.

(c) Even if the buy-sell agreement does not satisfy the requirements to fix the estate tax value, it still may have a depressing effect on the value for estate tax purposes. However, in such case, careful attention should be given to:

(i) The source of the payment of any estate tax on the value in excess of the purchase price under the agreement.

(ii) The effect on the marital deduction since the value may be reduced because of the agreement, even though IRS disregards the buy-sell price for estate tax purposes. See TAMS 9139001 and 9147065.

(iii) The effect on charitable deductions. In Estate of Schwan v. Commissioner, 82 T.C.M. 168 (2001) an estate transferring a 66 % interest in the stock of a corporation to a private foundation was required to include the controlling interest in the gross estate with a control premium, but was allowed a charitable deduction only at discounted values because the buy-sell agreement was only effective after the date of death (not before) and the agreement contained value lessening features in the hands of the redeeming charity due to ambiguity and other factors.

viii. Modifications of buy-sell agreements entered into before October 9, 1990 should be carefully scrutinized to avoid losing the grandfather protection if the existing agreement satisfies the requirements applicable before Sec. 2703.

(i) If a family member becomes an owner after

October 8, 1990, and adding him/her as a party to the agreement would be considered a material modification, a separate agreement with the new owner may avoid losing the grandfather protection.

(ii) If the pricing formula is suggestive of litigation (e.g., "book value"), consider modifications to clarify the formula. However, a change from book value to a fixed price was held to be a substantial modification, with the result that the agreement, no longer grandfathered, failed the comparability requirement of IRC §2703. Estate of Blount v. Commissioner, T.C. Memo 2004-116.

K. Leveraged ESOP's.

1. In general. Family owned businesses in C corporation form with a significant employee workforce may consider an employee stock ownership plan ("ESOP") as a market for the family business owner's stock.

2. Structure.

a. The corporation establishes an ESOP.

b. The business owner sells his or her shares to the ESOP, with all realized gain characterized as capital gain without the limitations of IRC §302.

c. The ESOP finances the stock purchase with a loan from a commercial lender, often guaranteed by the employer with the purchased securities pledged as collateral.

d. The employer corporation services the bank debt with tax deductible contributions or deductible dividend payments to the ESOP.

e. The leveraged ESOP approach reduces the overall after-tax cost of the stock acquisition over conventional debt financing because the loan is repaid on a fully tax-deductible basis rather than deductible only as to the interest element.

f. The business owner selling to the ESOP may elect not to recognize the capital gain if the seller purchases "qualified replacement property" under IRC §1042:

(1) After the sale, the ESOP must hold at least 30% of either (a) each class of outstanding stock (other than certain non-voting, non-convertible preferred stock) or (b) the total value of all stock (other than certain non-voting, non-convertible preferred stock).

(2) The seller files a written statement with IRS.

(3) The seller must have held the stock sold for at least 3 years prior to the sale.

(4) The closely-held business is a domestic C corporation with no publically traded stock.

(5) The seller must reinvest in stock of a domestic operating corporation within a period which begins 3 months before the sale and ends 12 months after the sale.

(6) The income tax basis in the qualified replacement securities is reduced by the amount of gain which is not recognized.

(7) The deferred non-recognition of gain is recaptured on disposition of the qualified replacement securities, except for dispositions in tax-free reorganizations, at death, by gift, or in another Section 1042 transaction.

VI. <u>CONCLUSION</u>

A closely-held family business presents unique challenges to the estate planner, but an opportunity to fully utilize the varied skills of the attorney and certified public accountant working together to analyze, install and carry out a comprehensive business succession plan.

JOHN A. ROUCHELL

Biography

John Rouchell is a New Orleans native and Jesuit High School graduate. He attended Tulane University receiving a bachelor's degree in English. He received a J.D. at Tulane Law School in 1976 and attended New York University where he received a LL.M. in Taxation in 1977.

John joined the Firm in 1980, and became a partner in 1983. He is currently a member of the firm's Executive Committee. His practice covers all aspects of state and federal tax law, as well as corporate and business law, estate planning and administration. He also represents authors, artists, and musicians in the New Orleans area, including his only child, John Michael, a professional musician and songwriter since the age of thirteen.

John enjoys playing the guitar and attending his son's concerts (MyNameIsJohnMichael). John is a Fellow of the American College of Trust and Estate Counsel. Since 1995, John has been recognized by ***Louisiana Super Lawyer*** (Estate Planning & Probate and Tax) and ***Best Lawyers in America***(Business Organizations, Closely Held Companies and Family Businesses Law, Corporate Law, Elder Law, Tax Law, Trusts & Estates). Since 2013, ***New Orleans Magazine*** has recognized John as one of their "Top Lawyers of New Orleans" for his work in Elder Law, Tax Law and Trusts & Estates.

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GRANTOR TRUSTS: USES AND ABUSES

By:
John A. Rouchell

I. Introduction

A. Background.

The grantor trust rules set forth in IRC §§ 671 through 679 originally were enacted to limit income splitting by creating multiple trusts as separate income taxpayers to mitigate graduated marginal rates.

However, since 1993, trusts have reached the maximum marginal income tax rates at comparatively low levels of taxable income. For 2015, the maximum marginal trust rate of 39.6% applies to trust taxable income over $7,500. IRC §§ 1(e) and 641(a).

As a result, estate planners now utilize grantor trusts which are ignored for federal and state income tax purposes, but which facilitate the shift of future appreciation in value to younger generations for gift, estate and generation skipping transfer purposes.

The estate planning techniques include installment sales to grantor trusts, zero-out GRATs, grantor CLATs and grantor life insurance trusts.

II. Which Grantor Trust Power to Select?

A. In General.

The goal is to choose a retained power under IRC §§671 through 679 which will cause the trust to be fully grantor and ignored for federal/state income tax purposes, but which can receive completed gifts for transfer tax purposes which will not be returned to the grantor' gross estate for federal estate tax purposes under IRC §§2035 through 2041.

The discussion which follows assumes that the underlying applicable trust law is the Louisiana Trust Code [1], LSA R.S. 9:1721-2252, with all of its estate planning limitations such as: (i) immediate vesting of principal interests of irrevocable trusts (RS 9:1971 and 2011-2014); (ii) limitations on class trust terms to three generations (RS 9:1891); and (iii) prohibition on overt use of powers of appointment (RS 9:1723; see also, Civil Code Art. 1572). Will the selected retained power be enforceable under the Louisiana Trust Code? Should the planner use the same retained power for all grantor trusts or should the planner select different retained powers, depending on the specific facts and circumstances?

B. Non-fiduciary Power to Substitute Trust Assets; IRC §675(4)(C).

[1] "Grantor" is used herein as a synonym for "settlor" under the Trust Code.

1. <u>In General</u>. The most popular retained power appears to be the non-fiduciary power to substitute assets of equivalent value after Rev. Rul. 2008-22, 2008-16, I.R.B. 796, favorably ruled that estate tax inclusion should not result in most cases.

2. <u>Income Tax</u>. The grantor is treated as the owner for federal income tax purposes of any portion of the trust in respect of which a power of administration is exercisable in a non-fiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. "Power of administration" includes a power to "reacquire" trust principal or corpus by substituting other property of equivalent value. IRC §675(4)(C).

   (i) "<u>Non-fiduciary</u>." Normally, the grantor, rather than the trustee or other third party, holds the power. Whether the power of substitution is held in a non-fiduciary capacity depends on the terms of the trust and all of the facts and circumstances. Reg. §1.675-1(b)(4)(iii). The trust instrument should expressly give the grantor the power of substitution "in a non-fiduciary capacity without the approval or consent of any person in a fiduciary capacity." It is important to specifically negate any fiduciary capacity of the grantor in the trust instrument since the grantor could owe a fiduciary duty by virtue of a relationship outside of the trust, such as in the capacity of a majority equity owner in an entity in which the trust is a minority owner. The trustee clearly is a fiduciary under the Trust Code (and any other state trust law). As a result, the trustee as a fiduciary must determine if the assets to be exchanged are of equivalent fair market value, but must not be given the express authority to veto the exchange. Ever since 1990, IRS has refused to privately rule whether, in a given fact situation, a power to substitute trust assets is held in a non-fiduciary capacity. PLR 9037011 (Sept. 14, 1990). <u>See</u> <u>also</u>, PLR 2007-09012 (March 2, 2007).

   (ii) "<u>Acquire vs. Reacquire</u>." IRC §675(4)(C) uses the word "reacquire." Nevertheless, IRS has ruled that the statute should be construed as if the word "acquire" had been used, such that the grantor could acquire trust assets that were originally contributed to the trust by others. This is supported by a number of private letter rulings authorizing a third party's holding of a power of substitution, as in their sample *inter vivos* charitable lead trusts. <u>See</u>, for example, Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (June 2, 2007).

(iii) "Equivalent Value." IRC §675(4)(C) uses the term "equivalent value," not "equal" value or "fair market" value. Neither the Code nor the Regulations provide a definition. Does the term simply require equal fair market values or is a more complex fiduciary analysis required to review income production, basis, liquidity, etc.? IRS appears to look solely to equal fair market value based on the gift tax Regulation standards. See, PLR 200846001 (Nov. 14, 2008).

(iv) Income Tax Consequences of Swap.

The grantor is deemed to own both the trust assets and the replacement assets and, consequently, the exercise of the power is a non-event for income tax purposes. Rev. Rul. 85-13, 1985-1 C.B. 184.

(v) State Jurisprudence.

A Michigan Court of Appeals has ruled that a substitution clause imposes a duty on the trustee to determine if value equivalence is established, but once established, the trustee does not have the discretion to deny the substitution. The grantor in this case unsuccessfully argued that the exchange must take place on the grantor's demand, and if value is later found not equivalent, the trustee should simply ask for more assets at a later date. *In re Dino Rigoni Grantor Trust*, No. 321589, 2015 WL 4255417 (Mich. Ct. App. July 14, 2015). This case may influence the outcome of *Benson v. Rosenthal*, No. 15-782 (E. D. La.).

3. Estate Tax. In Rev. Rul. 2008-22, 2008-16 I.R.B. 749 (Sept. 21, 2008), IRS ruled that IRC §§2036 and 2038 will not cause inclusion in the grantor's gross estate of property transferred to a grantor trust as a result of a reserved non-fiduciary power to substitute trust assets if:

(i) Fiduciary Obligation. The trustee (who was not the grantor in the Ruling) has a fiduciary obligation to ensure that the grantor is in compliance by satisfying itself that the properties exchanged are of equivalent value, citing *Estate of Jordhal v. Comm'r,* 65 T.C. 92 (1975), acq. 1977-2 C.B.1.; and

(ii) No Shift of Benefits. The substitution power cannot be exercised in a way that would shift benefits among the trust beneficiaries.

(a) The trustee must have the power (under local law or the trust instrument) to reinvest the trust corpus;

(b) The trustee must have a duty of impartiality among the trust beneficiaries; and

(c) The nature of the trust's investments or the level of income produced by the trust investments does not impact the respective interests of the beneficiaries, as in a unitrust or when distributions are limited to discretionary distributions of principal and income. It is unclear just what this third requirement means. Is it satisfied if the beneficiaries of the trust have equal, separate shares or must the trust instrument require all income to be distributed currently?

(iii) Closely-Held Equity. If the equity interest transferred to the grantor trust is of an entity treated as a corporation for income tax purposes (i.e., an L.L.C. electing "S" status), would the power to substitute other assets for trust voting stock violate IRC §2036(b)? IRC §2036(b), by its terms, applies only to closely-held corporations. In those cases, consider recapitalizing the corporation with voting and non-voting stock under IRC §368(a)(1)(E), and thereafter transferring only the non-voting stock to the grantor trust. Rev. Rul. 81-15, 1981-1 C.B. 457.

(iv) Life Insurance. In *Estate of Jordhal*, supra, a life insurance policy insuring the grantor's life was acquired by the grantor trust. The Tax Court held that the substitution of asset power retained by the grantor was not an IRC §2042 incident of ownership. IRS acquiesced to *Jordhal* at 1977-2 C.B. 1. In *Estate of Smith v. Comm'r*, 73T.C. 307 (1979), the Tax Court held that the right to buy a life insurance policy at any time for its cash surrender value is not an incident of ownership of the insured. IRS has acquiesced in the result only, at 1981-1, C.B. 2, and has not withdrawn Rev. Rul. 79-46, 1979-1 C.B. 303, in an employment setting where it ruled that an employee's power to acquire an employer-owned policy was an incident of ownership.

4. Trust Code. The Louisiana Trust Code generally defers to the trust instrument to determine the powers and duties of the trustee. R.S. 9:2061. However, a trustee cannot be relieved of the duty of loyalty to the beneficiaries by either the settlor or the beneficiaries. R.S. 9:2062 and 2063. Additionally, a trustee must administer the trust impartially and may not favor one or more beneficiaries over the others. R.S. 9:2082. These principles appear to be universal in all 50 states. Certain acts of self-dealing are permissible for individual, non-corporate trustees, if the trust instrument so provides. R.S. 9:2084 through 2086. The trustee acts as a prudent administrator as to investments and can acquire all types of investments, considering the purposes and circumstances of the trust. R.S.

9:2090 and 2127. A trustee can sell, mortgage or pledge trust property, unless the trust instrument provides otherwise. R.S. 9:2119 and 2120. Based upon the foregoing, a carefully drafted grantor trust with retention of substitution powers by the grantor should be permissible under the Louisiana Trust Code.

C. Power to Alter Beneficial Enjoyment; IRC §674.

1. In General. This approach involves a grantor trust that gives a non-adverse trustee (a related or subservient person to the grantor) broad powers to distribute, apportion or accumulate income and to distribute principal unfettered by ascertainable standards, often with a power (usually a common law power of appointment) in a non-adverse party to add beneficiaries (other than after-born or after adopted children).

2. Louisiana Trust Code. This approach is popular in common law states whose trust laws permit contingent interests in trust principal, powers of appointment, etc. As a practical matter, the Louisiana Trust Code's requirement of immediate vesting of trust principal, and the general Louisiana prohibition of powers of appointment and other limitations make this approach unworkable for Louisiana trusts. Note, however, that LSA R.S. 9:2031 permits a settlor of a Louisiana trust to delegate to another the power to add or eliminate beneficiaries or modify their rights when all of the affected beneficiaries are descendants of the person given such powers, provided no beneficiary's legitime is impinged. This is the equivalent of a common law power of appointment.

D. Other Approaches (?).

1. Power to Borrow Trust Assets. IRC §675(2).

This approach involves a grantor trust which permits the grantor to borrow trust corpus or income without adequate interest or without adequate security. Although the Louisiana Trust Code would seem to permit this if the trust instrument so provides (See, R.S. 9:2127), this approach is not recommended because the power could cause inclusion of trust assets in the gross estate of the grantor for federal estate tax purposes under IRC §2036(a)(2). *Estate of Paxton v. Comm'r*, 86 T.C. 785 (1986).

2. Amounts Distributed / Accumulated for Spouse. IRC §677.

This approach may only work for a grantor's separate property transferred to a trust whose income is or may be distributed or accumulated for the grantor's spouse, without an adverse party's consent. Although there should be no inclusion in the estate of the grantor or in the estate of the grantor's spouse (unless the trust is a marital deduction trust over which

QTIP has been elected), this approach is not often used because grantor trust status ends on the death of the spouse, even if the grantor is still living.

3. Amounts to Pay Life Insurance Premiums on Life of Grantor or Spouse. IRC §677(a)(3).

The only precedent is Rev. Rul. 66-313, 1966-2 C.B. 245, which holds that IRC §677(a)(3) limits grantor trust status to trust income actually used to pay premiums on the life of the grantor or the grantor's spouse. There are some private letter rulings which indicate possible full grantor trust status. See, for example, AGR 8007080 (Nov. 26, 1979). As a result, this approach is not recommended for grantor trust planning.

E. Crummey Powers.

Does the presence of a Crummey withdrawal power in the grantor trust instrument mean that the beneficiaries holding the power are the "grantors" instead of the intended grantor/settlor? IRC §678(b) implies that a beneficiary of a trust is not treated as owning any portion of the trust if the grantor is otherwise treated as the owner. IRS has so privately ruled. See, for example, PLR 2008 42007 (October 17, 2008), although some commentators believe the taxpayer favorable private letter rulings are analytically incorrect.

III. Termination of Grantor Trust Status

A. During Grantor's Lifetime.

1. In General. The termination of grantor trust status while the grantor is living is treated as a new constructive transfer of the trust's assets by the grantor to the trust as a separate income taxpayer, in exchange for any consideration that the grantor may receive in the transaction. Reg. § 1.1001-2(c), Ex. 5; Rev. Rul. 77-402, 1977-2 C.B. 222; *Madorin v. Comm'r* 84 T.C. 667 (1985). The transaction at that time should be income tax free as a gift for income (but not gift tax) purposes, except for assets with liabilities in excess of basis, which could include interests in LLCs taxed as partnerships or limited partnerships with negative capital accounts.

B. At the Grantor's Death.

1. In General. Although there appears to be no direct authority in the Code, Regulations or jurisprudence, the commentators generally believe that since death is not considered to be an income tax recognition event, the grantor should be treated for income tax purposes as if he/she owned and transferred the trust assets (even encumbered assets with liabilities in

excess of basis) in a traditional testamentary transfer, free of income tax consequences. Rev. Rul. 85-13, supra. Blattmachr, Gans & Jacobsen, "*Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*," 96 J. Tax'n 149 (Sept. 2002). See also, Chief Counsel Advice 2009 23024 (June 5, 2009).

2. Installment Notes. Will an installment note held by the grantor due from the grantor trust obtain a basis adjustment under IRC §1014(b), or will it be an item of income in respect of a decedent ("IRD") under IRC §§61 and 1014(c)? The installment note is an asset of the grantor's gross estate at death, even though it is not a debt obligation under Rev. Rul. 85-13, supra. Arguably, the note would be entitled to a Section 1014 basis adjustment. If the grantor had lived, there would have been no income tax recognition on repayment, so the note, arguably is not IRD. IRC §691(a)(3).

3. Trust Assets. The Trust's assets are not included in the grantor's gross estate and, consequently, should receive no IRC §1014 basis adjustment.

4. Planning Considerations.

   (i) Consider paying off the installment note before the grantor's death by an in-kind transfer to the trust of high-basis assets in settlement of the debt.

   (ii) Consider having the grantor purchase low-basis assets of the grantor trust with cash or other high-basis assets to maximize the positive effect of the adjustment under IRC §1014.

IV. **Toggling of Powers**

A. Elimination.

The release by the grantor of the applicable power should have no income tax consequence unless the trust holds assets with liabilities in excess of basis. Reg. §1.1001-2(c), Ex. 5; Rev. Rul. 77-402; supra; *Madorin v. Comm'r,* supra. The ability to turn off grantor trust status should be retained by the grantor and not be given to the trustee since the elimination of the power would cause the trust to be the income taxpayer of the income derived from the trust assets and could be a breach of a fiduciary duty of the trustee owed to the beneficiaries. Presumably, any grantor-held installment obligation of the trust becomes taxable to the grantor under the installment method of reporting at that point in its amortization. The trust will commence filing fiduciary income tax returns at that point.

B. Re-Start.

The income tax consequences to the grantor of re-starting grantor trust status are less clear. However, the IRS Chief Counsel has opined, for what it's worth, that Reg. §1.1001-2(c), Ex. 5, Rev. Rul. 77-402 and *Madorin*, supra, are limited to conversions from non-grantor to grantor status, and that, consequently, the re-start to grantor status is not a deemed new transfer of assets to the trust which would trigger gain, presumably even if the trust has an asset with liabilities in excess of basis. It may not be appropriate to give the grantor (with the power to eliminate grantor trust status) the power to re-start grantor trust status, since that could cast doubt on the validity of the elimination in the first place. Furthermore, would IRS argue IRC §2036 inclusion if a non-adverse third party holds the power to re-start grantor trust status. Upon re-start will the trust be "terminated" such that IRC §642(b) will permit losses to pass-through to the trust beneficiaries, to the grantor or not at all? Will suspended passive losses of the trust remain suspended, be added to basis, or be lost?

C. Abusive Transactions.

IRS has announced in Notice 2007-3, 2007-36 I.R.B. 545 (Sept. 4, 2007) that certain grantor trusts that can toggle grantor status on and off in order to avoid gain or to claim a tax loss in excess of economic loss involving options are abusive transactions requiring tax return statements, reportable transaction disclosures and lists under IRC §§6011, 6111 and 6112.

The Notice appears to be limited to specific types of tax shelter transactions and does not suggest that toggling is per se questionable.

V. **Installment Sales to Grantor Trusts**

A. In General.

An estate "freeze" of the client's appreciating assets can be achieved by transferring assets to a family limited liability company or limited partnership, followed by a part gift/part installment sale of a non-marketable, minority equity interests to one or more grantor trusts for the benefit of younger generations.

1. Transfer tax valuation discounts are fully utilized to leverage transfer tax exemptions and exclusions.

2. An otherwise appreciating asset is converted into a fixed yield, non-appreciating installment promissory note.

3. The installment sale to the grantor trust is not recognized for federal and state income tax purposes. There is no capital gain on the sale and the interest element of the debt service is not income to the grantor or deductible by the trust or its beneficiaries. Rev. Rul. 85-13 1985-1C.B. 184. There should be no gain recognition even if the note is not paid in full prior to the grantor's death (although there is some uncertainty in this regard).

4. The grantor continues to report the taxable income of the trust as if the grantor still retained the transferred assets. Since the trust is ignored for federal and state income tax purposes, the grantor's payment of the income tax generated by the grantor trust's assets is the payment by the grantor of his/her own tax liability and, consequently, is not a gift to the trust or its beneficiaries, even though this permits the trust assets to grow faster. Rev. Rul. 2004-64, 2004-2 C.B. 7. Reimbursement of the income tax by the trust will not cause inclusion of the trust assets in the grantor's estate under IRC §2036 if the trust instrument (or local law) gives the Trustee the discretion, but not the obligation, to reimburse the income tax. Rev. Rul. 2004-64, *supra.* The Louisiana Trust Code does not address this issue. Furthermore, the grantor's payment of the income tax from other assets further reduces the grantor's assets that otherwise would be subject to estate tax. Economic studies have indicated that the payment of income taxes on income generated by the assets of the grantor trust (free of gift status) is the single greatest transfer tax saving factor, even more beneficial than transfer tax valuation discounts.

5. The grantor trust can facilitate income tax basis planning. For example, the grantor could repurchase or reacquire low-basis assets from the grantor trust, thereby setting up the low basis assets received for a basis increase at the grantor's death under IRC §1014(a). The one year limitation of IRC

§1014(e) should not apply since the decedent will not have acquired the low-basis property by gift.

B. <u>"Seeding" the Trust</u>. In theory, a true lender would not extend credit to a trust if the only assets of the trust were assets sold to the trust for an installment note.

1. For the grantor to be the "actual grantor" or settlor for income tax purposes, property must be contributed to the trust as corpus and not all of the trust principal being sold by the grantor. Reg. §1.671-2(e)(1). Would a minimal contribution ($100.00) be enough for corpus to create a "grantor" trust?

2. The conventional wisdom is that a minimum of 10 to 15% of total trust corpus should be donated in order to insulate against an IRC §2036 attack that the installment note is not debt but retained equity. The origin of 10% appears to be by analogy to the 10% minimum value rule in IRC §2701(a)(4)'s requirement for minimum junior equity in the corporation/partnership area. <u>See</u> also, PLR 9535026 (Sept. 1, 1995).

3. Can a personal guarantee suffice to replace the seed gift if the guarantor(s) have sufficient personal net worth to cover the installment obligation? Must the guarantee be secured by a pledge of collateral? Should the trust pay the guarantor a guarantee fee? Is the guarantor making a taxable gift to the beneficiaries of the trust?

4. Should the seed donation take place and be "aged" before the installment sale and, if so, for how long? In *Pierre v. Comm'r*, T.C. Memo 2010-106, interests donated and sold on the same day were aggregated for valuation discount purposes on a step transaction theory. <u>See</u> also, a number of cases in the family limited partnership/family LLC area where IRS argued that funding of the entity followed by a gift of entity interests shortly thereafter should be treated as gifts of the underlying assets. *Senda v. Comm'r*, T.C. Memo 2004-160, aff'd 433 F.3d 1044 (8^{th} Cir. 2006); *Estate of Mirowski v. Comm'r*, T.C. Memo 2008-74, for example. If the donation and sale were aggregated, perhaps IRS could argue that the installment note was undervalued and would not satisfy the adequate consideration exception to IRC §2036. It has been suggested by certain commentators that a thirty (30) day delay would be sufficient.

C. <u>Interest Rate</u>. Is the applicable federal rate under IRC §§1274(d) and 7872 appropriate? There is authority supporting the use of the AFR for installment sale transactions. *Frazee v. Comm'r*, 98 T.C. 554 (1992); *True v. Comm'r*, T.C. Memo 2001-167, aff'd on other grounds, 390 F.30 1210 (10^{th} Cir. 2004); PLR 9535026.

D. <u>Legislative Proposals</u>

On February 2, 2015, the Obama Administration released its General Explanation of the Administration's Fiscal Year 2016 Revenue Proposals (the "Greenbook") which set forth its legislative "wish list."

In addition to proposing that gifts and death be income tax realization events for the first time in the history of the federal income tax, the elimination of the IRC §1014 basis adjustment (termed by the President… "perhaps the largest single loophole in the entire individual income tax code…"), elimination of zero-out GRATs, limiting GST trusts to 90 year terms, and other equally taxpayer friendly proposals, the Administration wishes to outlaw sales to grantor trusts.

The 2013 Greenbook would have included all grantor trusts in the grantor's gross estate for federal estate tax purposes.

The 2014 Greenbook narrowed the proposal. If there are sales to grantor trusts, the portion in the trust attributable to the sale (net of the consideration received by the grantor in the transaction) would be included in the grantor's gross estate (or would be a gift by the grantor if grantor trust status terminated during the grantor's lifetime).

The 2015 Greenbook clarified that the proposal would not apply to life insurance trusts, apparently after a number of estate planning practitioner concerns were raised.

The 2016 Greenbook proposal adopts the 2015 Greenbook with an effective date for grantor trusts that engage in a "…sale, exchange or similar transaction" on or after the date of enactment.

The 2016 Greenbook estimates that the proposal would result in $1.644 Billion in revenue over ten (10) years.

E. <u>IRS Attack – Woelbing Estate Litigation</u>

1. <u>Woelbing</u>. On December 26, 2013, two companion cases were filed in the Tax Court, *Estate of Donald Woelbing v. Comm'r*, Docket No. 30261-13 and *Estate of Marion Woelbing v. Comm'r,* Docket No. 30260-13, the outcomes of which will have a major impact on planning for sales to grantor trusts.

2. <u>Facts</u>. In 2006, H sold all of the non-voting stock of a closely-held family business to a grantor trust for its appraised value of $59 Million in exchange for a promissory note bearing interest at the AFR with a *Wandry* style valuation formula clause. The trust also owned three life insurance policies insuring H and W's lives. The children of H and W who were the trust beneficiaries executed personal guarantees of 10% of the face value

of the note. H and W filed gift tax returns agreeing to split gifts. H died in 2009. W died in 2013, two days after receiving an IRS notice of deficiency of $32 Million against her for additional gift tax, interest and penalties.

3. IRS Positions.

(i) Gift Tax. That the value of the stock was $116.8 Million instead of the $59 Million purchase price, and that the note has zero value under IRC §2702 (the note being a continuing equity interest in the trust which should have a zero value since not a guaranteed annuity under the GRAT exception). Alternatively, if IRC §2702 does not apply, the taxable gift is the excess of the fair market value of the stock over the fair market value of the note received in exchange for the stock (an apparent attack on the sufficiency of interest at the AFR).

(ii) Estate Tax. The note is not an asset of H's estate but, rather, the stock sold should be included in H's estate instead under IRC §§2036 and 2038 at the stock's date of death value.

(iii) Deficiency. The combined gift and estate tax liabilities proposed exceed $125 Million, plus more than $25 Million in 20% understatement penalties.

4. Comment.

Apparently, similar IRS arguments have been made in other cases recently that have been settled favorably to the taxpayer and, consequently, have not been reported, such as *Karmazin v. Comm'r*, Docket No. 2127-03 (filed Feb. 10, 2003). Some commentators have suggested that *Woebling* is really a simple valuation case which may be settled on that basis. Nevertheless, the *Woebling* cases should be followed by planners using sales to grantor trusts since many of the questions raised in this outline are at issue in the cases.

5. Status.

The cases were removed from the Court docket in order to permit settlement (presumably on the basis that the case is merely a valuation issue), but has since been placed back on the Tax Court trial calendar for February 29, 2016.

VI. Zero-Out GRAT

A. In General.

An alternative to the installment sale to a grantor trust is the transfer of appreciating property to a grantor retained annuity trust (“GRAT”) which pays to the grantor a sizeable annuity over a short fixed term which satisfies the requirements of IRC §2702(b) such that the actuarial present value of the annuity payments at the applicable IRC §7520 rate will equal the fair market value of the property transferred, thereby reducing the gift tax value of the remainder interest to zero (“Zero-Out GRAT”).

The annuity must be a “qualified interest” under IRC §2702(b), namely, a fixed amount which is a percentage of the fair market value of the property transferred, payable at least annually, otherwise the value of the retained interest will be deemed to be zero, thereby rendering the taxable gift equal to the full fair market value of the property transferred. IRC § 2702(a)(2)(A); Reg. §25.2702-1(b). Although a unitrust interest can satisfy the requirements of IRC §2702(b), actuarially, it cannot result in a remainder interest with a zero value.

A GRAT is a grantor trust because the grantor receives the trust income within the meaning or IRC §677(a)(1). As a result, an IRC §675(4)(C) power in the GRAT instrument is not necessary, but is often used.

B. <u>Statutory / Regulatory Requirements</u>.

1. The income interest must be a “qualified annuity “interest” and the principal interest must be a “qualified remainder interest,” valued under IRC §7520 as for charitable split interest trusts under IRC §664. Reg. §25.2702-2(b)(2) and (c).

2. The qualified annuity interest must be:

   (a) Paid periodically but at least annually;

   (b) A fixed fraction or percentage of the initial fair market value of the property transferred to the trust as finally determined for federal tax purposes;

   (c) Can be in unequal amounts, provided the fraction or percentage does not exceed 120% of the fraction or percentage payable in the preceding year; and

(d) The trust instrument must provide for adjustment of payments for incorrect valuations of property transferred to the trust as for charitable split interest trusts.

Reg. §25.2702-3(b).

3. The trust instrument must prohibit additional contributions to the trust after the initial funding. Reg. §25.2702-3(b)(5).

4. The annuity must be payable to the income beneficiary for the fixed term of the interest and must not be subject to any contingency other than the holder's survival throughout the term. Reg. §25.2702-3(d)(2).

5. The trust instrument must provide that payments to anyone other than the holder of the income interest is prohibited during the trust term. Reg. §25.2702-3(d)(3).

6. The trust instrument must provide for a term that is fixed and ascertainable on the date of creation of the trust, which must be for the life of the income beneficiary, a term of years or the shorter (but not the longer) of the two periods. Reg. §25.2702-3(d)(4).

7. The trust instrument must prohibit commutation (prepayment) of the annuity. §25.2702-3(d)(5).

8. The trust instrument must prohibit the trustee from issuing a note, other debt instrument, option or other similar financial arrangement in satisfaction of the annuity payment obligation. Reg. §25.2702-3(d)(6).

9. The income interest must be a "qualified annuity interest" in all respects. A hybrid of the annuity and unitrust will not qualify. Reg. §25.2702-3(d)(1).

10. Generally, if the income interest is a qualified annuity interest, the principal interest should be a "qualified remainder interest" if it is non-contingent. §25.2702-3(f).

C. Required Growth.

If the assets transferred to the Zero-Out GRAT experience a blended total rate of return (income and capital appreciation) in excess of the IRC §7520 applicable rate, the excess value will be distributable to the younger generation principal beneficiary free of transfer tax at the end of the GRAT term.

1. Even if the total return exceeds the IRC §7520 rate, the Zero-Out GRAT can still fail if it experiences losses in the earlier year(s), even if followed by offsetting very high gains in the later year(s), because the annuity is paid from a shrinking base. This can be offset somewhat by having a smaller payment in the early year(s), but later year payments can exceed the preceding year by only 120%. Reg. §25.2702-3(b)(1)(ii).

2. If the Zero-Out GRAT fails, all of the transferred assets are returned to the grantor and the principal beneficiary receives nothing at the end of the term. However, the grantor will not have depleted his or her lifetime exemption in the process.

3. If the Zero-Out GRAT's investment performance is successful, a very large annuity (usually in excess of 50%) will be due, requiring a redistribution back to the grantor of a portion of the principal originally transferred. At that point, the property received can be re-transferred by the grantor to a new Zero-Out GRAT in a laddered sequence.

4. If the grantor dies during the trust term, all trust assets are returned to the grantor's gross estate under IRC §2036(a)(1).

D. <u>Comparison to Sale to Grantor Trust</u>.

1. <u>Safety</u>. The Zero-Out GRAT is perceived as a technique specifically sanctioned by the Code and Regulations, and, consequently, safer from IRS audit and litigation attack than the installment sale to a grantor trust as in the *Woelbing* cases. The Greenbook wish list would legislatively eliminate the zero-out feature.

2. <u>Discount Rate</u>. The installment sale has an interest rate hurdle of the applicable federal rate on the installment note under IRC §1274(d). The GRAT interest rate hurdle is the applicable discount rate under IRC §7520 which is 120% of the mid-term applicable federal rate, normally a higher target.

3. <u>Death During the Term</u>. The installment note will be included in the grantor's gross estate, unless a self-canceling installment note (SCIN). IRS takes the position that the entire corpus of the GRAT is included in the grantor's gross estate. Rev. Rul. 82-105, 1982-1 C.B. 133; TAM 2002 10009.

4. <u>Generation Skipping</u>. An installment sale can be made to a grantor trust for the benefit of grandchildren to which the GST exemption can be allocated. Under the estate tax inclusion period ("ETIP") rules of IRC §2642(f), the GST exemption cannot be allocated to a GRAT until the trust terminates, thereby preventing a GRAT from leveraging the GST

exemption. Can a zero-out GRAT be created with the principal beneficiary being the grantor's child (a non-skip person), who, thereafter transfers the interest in principal to the grantor's grandchildren (or a trust solely for their benefit)? IRS takes the position that the original grantor continues as the GST "transferor." PLR 200107015. Furthermore, to eliminate the GST exposure, the amount of the GST to be allocated would have to be the full amount of the property transferred to the GRAT and not just the amount of the gift tax value of the remainder interest. IRC §2642(a)(2)(A). Thus, the GST exemption is wasted as the annuity is repaid to the GRAT grantor.

5. Use of Transfer Tax Exemption. The "seeding" of the grantor trust of 10 to 15% with an installment sale will require partial or complete depletion of the grantor's transfer tax lifetime exemption. A Zero-Out GRAT does not use any of the exemption since no taxable gift is involved.

6. Revaluation Risk. GRAT trust instruments generally contain adjustment clauses which increase the annuity amount if the transferred property is undervalued. Can a similar protection apply to an installment sale utilizing *Wandry* language to avoid an inadvertent gift if the transferred property valuation is later adjusted in an IRS examination?

E. Legislative Proposal.

The 2016 Greenbook proposal effectively would legislatively eliminate Zero-Out GRATs formed after the date of enactment.

1. A 10 year minimum term requirement.

2. A maximum term of life expectancy plus 10 years.

3. A remainder value greater than zero. The GRAT at creation must have a minimum remainder value equal to the greater of 25% of the value of the assets contributed to the GRAT or $500,000 (but not more than the value of the assets contributed).

4. Prohibition on GRATs engaging in tax-free exchanges of assets held in trust.

VII. Zero-Out CLAT

A. In General.

For those clients with philanthropic interests, and during periods of low interest rates, a charitable lead annuity trust ("CLAT") can be structured much like a Zero-Out GRAT to minimize the gift element, particularly if the next generation is financially secure and is in a position to wait for the transferred assets. The shorter the fixed term of the trust, the higher the amount of the charitable lead annuity necessary to reduce the present value of the remainder interest to zero ("Zero-Out CLAT"). The longer the trust term and the lower the applicable IRC §7520 rate, the smaller the required annuity to achieve zero-out status. A charitable lead unitrust ("CLUT") cannot be zeroed-out actuarially, but only a CLUT (and not a CLAT) can leverage the GST exemption.

Depending upon the circumstances, making an *inter vivos* Zero-Out CLAT a grantor trust may improve its estate planning benefits.

B. Income Tax Differences – Grantor v. Non-Grantor CLATS.

1. The donor receives no income tax charitable deduction for a gift to a non-grantor CLAT, although a gift tax charitable deduction applies to the charitable interest, thereby limiting gift tax exposure to the non-charitable interest. Reg. §§1.170A-6(c)(2) and 25.2522(c)-3(c)(2). If the CLAT is grantor, the donor may deduct for income tax purposes the present value of the charitable lead interest, subject to the 30% limit on AGI (20% for long-term capital gain property) and a 5 year carry-forward. IRC §§170(b)(1)(D) and 170(f)(2)(B); Reg. §§1.170A-6(c) and 1.170A-8(a)(2).

2. Unlike a charitable remainder trust, a CLAT is not itself a tax-exempt trust, but the CLAT is permitted to deduct against its own fiduciary income the lesser of the payments to the charity or its taxable income. IRC §642(c). An unused charitable deduction is lost on termination of the trust and cannot be transferred to the beneficiaries. IRC §642(h). A grantor CLAT is not recognized for income tax purposes, and all income generated by the trust is taxable to the grantor on his or her personal return.

C. Required Growth.

1. As with Zero-out GRAT, the Zero-out CLAT must achieve a total return (income and capital appreciation) in excess of the applicable IRC §7520 rate for anything to be available for the non-charitable beneficiary at the end of the trust term. Since a CLAT involves a charitable interest, the lowest IRC §7520 rate for the current month and the two immediately preceding calendar months may be used. Reg. §1.7520-2(a)(3). However,

even if the total return exceeds the IRC §7520 rate, the CLAT could fail nevertheless if losses are experienced in the early years. Failed CLATs can be embarrassing to a grantor if the CLAT is part of a pledged gift, no assets are transferred to family members, and the grantor does not receive the assets back (as in a Zero-Out GRAT) with no adverse consequences.

2. Unlike a GRAT, which can have increasing annuity payments each year (limited to 120% of the prior year annuity), a CRAT can have increasing payments without such limitation. This has been confirmed by IRS in Rev. Proc. 2007-45, 2007-29, I.R.B. 89. By back loading the charitable annuity payments, the investment risk of losses in early years of the CLAT can be reduced, thereby permitting "glide path" investing in more risky growth investments in early years. Some commentators have recommended structuring a Zero-out CLAT with token payments to the charity in amounts as low as $1,000 per year, with the final payment of the remaining present value of the property transferred reflected in the final annuity payment to the charity, citing Rev. Proc. 2007-45 as supporting authority for *inter vivos* CLATS and Rev. Proc. 2007-46, 2007-29 I.R.B. 102 for testamentary CLATs. These Zero-out CLATS are referred to as "Shark Fin" CLATs because the payments reflected on a horizontal graph looks like a shark's fin rising above the water line.

3. Certain "Monte Carlo" economic wealth forecasting studies have indicated that Shark-Fin CLATs generally are not as beneficial as CLATs with less aggressive back-loading, but that if the Shark-Fin CLAT is a grantor trust, the results can be superior to the non-grantor CLATs, and can also be superior to the results for installment sales to grantor trusts and Zero-out GRATs.

4. The primary reason for the reversal of outcome is the fact that a non-grantor Shark-Fin CLAT pays income tax on its earnings throughout the term of the trust, except for the last year, without much help from IRC §642(c) charitable income tax deduction because the deductible payments are very low until the last year of the trust. If the Shark-Fin CLAT is a grantor trust, the income generated by the trust assets is taxable to the grantor. Consequently, the trust assets grow free of income tax.

5. A Shark-Fin CLAT presumably could own investments that would not otherwise be appropriate for traditional CLATs because of volatility, lack of liquidity or low initial value but which may spike upward in value later in the life of the instrument (such as private equity or family LLCs/FLPs holding commercial real estate).

D. <u>Which Grantor Power</u>?

Rev. Proc. 2007-45, supra, has promulgated suggested IRS forms for CLATs, both non-grantor and grantor, and has suggested the use of the swap power under IRC §675(4)(C), provided that the power is given to an individual who is not a "disqualified person" under IRC §4946(a)(1). See, PLR 9224029. Perhaps an additional or different grantor trust power, for example, the power to name additional charitable beneficiaries, might be appropriate. See, PLR 199936031.

E. Termination of Grantor Status.

1. The termination of grantor trust status by relinquishment or death should result in no income tax consequences to the grantor as previously discussed, unless trust assets have liabilities in excess of basis.

2. However, there is a "recapture" of the grantor's charitable income tax deduction if the grantor has not effectively "given back" the up-front deduction in realized income to the grantor during the time the trust was a grantor trust on a discounted basis. IRC §170(f)(2)(B). The Regulations calculate the income recaptured as the amount of the up-front deduction allowed, reduced by the discounted value of all amounts required to be paid and actually paid to the charity. Reg. §1.170A-6(c)(4).

3. The trust then becomes a non-grantor trust entitled to the deduction under IRC §642(c).

F. Can the Grantor's Private Foundation be the Charity?

1. The Tax Court has held that a private foundation can be used as the charitable annuity or unitrust beneficiary of a charitable lead trust, declaring invalid Reg. §53.4942(a)-2(b)(2) to the contrary. *Ann Jackson Family Foundation v. Comm'r*, 97 T.C. 534 (1991), aff'd, 15 F.3d 917 (9th Cir. 1994). See also Notice 2004-36, 2004-1 C.B. 889.

2. IRC §2036(a)(2) may apply if the grantor of the CLAT is a member, officer or director of the foundation with the power to determine how the charitable distribution is to be spent. *Estate of Rifkind v. U.S.*, 5 Ct. Cl. 362 (1984); Rev. Rul. 72-552, 1972-2 C.B. 525. The issue may be avoided by naming other family members as officers and directors. PLR's 9821030 (May 22, 1998); 9822018 (May 29, 1998); 9822019 (May 29, 1998); 9822021 (May 29, 1998); and 200043039 (Oct. 27, 2000).

3. Although not a tax-exempt entity (such as a family foundation), a non-grantor CRAT nevertheless is subject to most of the same restrictions and penalty taxes as apply to the family foundation which is the GRAT income beneficiary, namely:

(i) IRC §508(a)'s governing instrument requirements to distribute income in a way to avoid the excise tax on undistributed income under IRC §4942.

(ii) Engaging in self-dealing under IRC §4941(d).

(iii) Retaining excess business holdings under IRC §4943(c).

(iv) Making jeopardy investments under IRC §4944.

(v) Making taxable expenditures under IRC §4945(d).

These provisions will not apply to a grantor CRAT itself but will apply to the private foundation which is the grantor CRAT charitable beneficiary.

VIII. Life Insurance Trusts

Grantor trusts also are excellent vehicles for life insurance trusts. If a life insurance trust is a grantor trust, it is ignored for all income tax purposes, including the transfer for value rules of IRC §101(a)(2). Thus, the grantor/insured is treated as the owner (for income tax purposes only) of the policy insuring the grantor's life that is legally owned by the trust. Such a trust will be treated as the "insured" and is a permissible transferee for value under the exception to the transfer for value rule. IRC §101(a)(2)(B). See, Rev. Rul. 2007-13, 11. I.R.B. 684 (March 12, 2007). This will facilitate unwinding of irrevocable life insurance trusts if the grantor has "buyer's remorse" after the trust has been created.

IX. Conclusion

The use of grantor trusts provide a number of valuable estate planning techniques for transmitting wealth to younger generations.

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