The following is adapted from a 2018 Article appearing in the Journal of Passthrough Entities

The Orwellian Look to the Future of Our Practice, or At Least our Estate Planning Practice in 2018

In the year 2525, will we pick out our child from a test tube or a computer screen? Neither; children will be selected from a thought process. We think, therefore you are.

If you created a trust in 1918, one hundred years ago, what would have been factors?

1. The world just finished a war.
2. Automobiles were becoming more plentiful.
3. Food was scary.
4. There were no commercial airplanes.
5. Working conditions were abysmal.
6. Babe Ruth was a pitcher for Boston.
7. Women did not have the right to vote.
8. And on and on.

How many of the factors that we are considering today will be relevant 25 years from now?

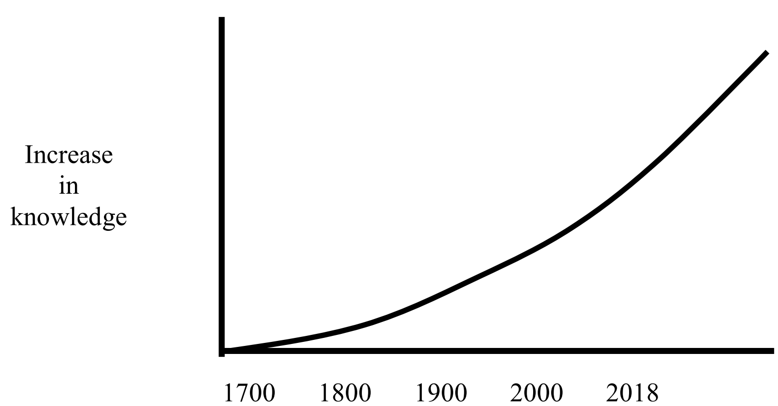
Well, some. Education, medical, and good character.

But how about security?

Domicile?

Security and domicile may be key points to our clients in 25 years, but they are not really part of trust structuring now.

In considering how we approach estate planning for clients, we should be cognizant that the rate of change in our society in terms of knowledge advancement is likely exponential, not linear.



Has the thought process in which we do estate planning changed at this pace too?

No, because we are subject to the behavioral finance status quo bias.

Here then are considerations for our immediate change.

1. **SPOUSAL FORMULA IN ESTATE PLANNING DOCUMENTS**

The two trusts, the three trusts, the multi trust solution for tax planning in Wills (living trusts) for spouses may be correct, but is no longer the default drafting choice. With the credit bouncing around from $1,000,000 to $11,180,000, indexed, who knows what tomorrow will bring. And states have, or don't have, inheritance taxes.

Recommendation One: Instead of complicated multi trust drafting, as has been done since 1982, the current environment militates in favor of the single-fund QTIP trust. It allows a practitioner to achieve tax planning for their client, as well as the following flexibilities:

1. For the portability decision to be decided at the surviving spouse's passing. Estates may want to include 100 percent of the property in the surviving spouse's estate to achieve a step-up in income tax basis. The goal will be either to make a partial QTIP election to create a credit shelter trust out of the non-elected portion (the $11.180 million estate tax exclusion amount) or a full QTIP election to put all the property in the surviving spouse's estate for basis step-up reasons.

2. For state inheritance tax to be avoidable at the first spouse's passing if that state has a QTIP marital deduction, even if that state has a credit that's decoupled from the federal credit.

3. Ease in drafting.[1]

4. Ease in client understanding.

5. Ease in administration until multiple trusts are created (post-mortem).

2. **MARRIED COUPLES**

Husband and Wife exist, but so do Spouse and Spouse, Husband and Husband, Wife and Wife, and in year in the future, *Spouse and Spouse and Spouse, or Other and Other, or Who knows what*?

Recommendation Two: Keep an eye on a trend away from husband and wife nomenclature in drafting. Perhaps in the short future drafting will be "Spouse and Spouse." For now, consider using "surviving spouse" versus "my husband" or "my wife." The term "spouse" fits perfectly into documents.

Recommendation Three: Estate planning discussions are easier in the context of "spouses," but limited powers of appointments to "descendants and **spouses** of descendants" can be a bit, as the name implies, limiting. Consider broader limited powers of appointment: "to anyone other than my creditors, my estate, myself, or creditors of my estate."

3. **IRREVOCABLE TRUSTS**

[1] For those of us who enjoy drafting, we know what the 3 trust plan looks like, with a state exempt, a federal exempt, and a federal QTIP trust all being in place. Throw in there a mismatch of remaining GST exemption from the unified credit, and we have a couple more trusts being called for. The client does not have a chance of recognizing the planning; and the drafter has a strong chance of, ummm, poor drafting if he or she hasn't done a lot of these. All these problems are eliminated with a single fund trust.

We used to be frightened with trust protectors to amend trusts. These powers are essentially providing a broad limited power of appointment to third parties.

Among the problems: Is this a 2036 power? Will this create undue IRS scrutiny? Well, the Times They are a Changin.

Guess what? A third party trust protector power, if properly set up, is not a 2036 power. It may be a power the powerholder does not want to have, but time to consider it in all trusts.

Recommendation Four: Consider protections in irrevocable trusts. Either special limited powers of appointment, broader trust protector provisions, express decanting powers.

a. Briefest approach:

"Power of Appointment by Special Power Holder. During my life, the trustee shall distribute the principal to any one or more of my spouse , my descendants, and the spouses of my descendants as the special power holder from time to time appoints during his or her life. I name as the special power holder the first of the following who is from time to time willing and able to act: (a) my friend and attorney, I. M. Ntroubl

(b) my friend and accountant, Hert M. Eeee."

b. More expansive Trust Protector provision, select provisions:

ARTICLE 1
Trust Protector

1.1 **Designation**. Dean shall be the initial Trust Protector. During my lifetime, [third party] may appoint any one or more qualified corporations, or any one or more individuals other than Disqualified Person as to me, as the initial Trust Protector, Co-Trust Protector, or successor Trust Protector of this trust or any separate trust created hereunder, to act with or to succeed the then acting Trust Protector consecutively or concurrently, in any stated combination, and on any stated contingency; provided that any such designation may be amended or revoked before the designee accepts office. The powers retained in this paragraph may be exercised by a signed instrument filed with the trust records, and any later instrument shall take precedence over an earlier instrument.

1.2 **Powers of Trust Protector**. The Trust Protector may exercise the following powers, at the sole discretion of the Trust Protector:

(a) To appoint successor trustees or co-trustees and remove and replace any trustee of such separate trust, in the manner and under the circumstances described in Article 5 hereinabove.

(b) To make a determination, upon the request of the trustee, of what constitutes reasonable compensation to the trustee.

(c) To change the domicile of the trust.

(d) To resign at any time by signed notice to the trustee.

(e) Subject to any plan created by me pursuant to the paragraph above, to designate any one or more qualified corporations, or any one or more individuals other than Disqualified Persons, as Co-Trust Protector or successor Trust Protector of this trust or any separate trust created hereunder, to act with or to succeed the Trust Protector consecutively or concurrently, in any stated combination, and on any stated contingency; provided that any such designation may be amended or revoked before the designee accepts office. The powers granted in this subparagraph may be exercised by a signed instrument filed with the trust records, and any later instrument shall take precedence over an earlier instrument. If any plan created under this subparagraph shall conflict with any plan created by me pursuant to the paragraph above, my plan shall prevail, whether it was dated earlier or later than the plan under this subparagraph.

(f) To distribute so much of the trust to any one or more of the Beneficiary's descendants, ancestors, siblings, or nephews or nieces in equal or unequal shares, as the Trust Protector shall appoint in writing delivered to the trustee.

1.3 **Release by Trust Protector**. The Trust Protector at any time acting may, by written instrument delivered to the trustee, irrevocably release any of the powers granted to the Trust Protector under this Article. If the Trust Protector irrevocably releases a power, such power shall thereafter no longer be exercisable by the Trust Protector or any successor Trust Protector.

1.4 **Disqualified Person**. The term "Disqualified Person" hereunder shall mean me, any person who has contributed property to such trust, any beneficiary of such trust, the spouse of any beneficiary of such trust, and any individual or entity who would be considered a "related or subordinate party" under Code Section 672(c) as to any of the foregoing such persons, had such person been the grantor of such trust (including without limitation such person's spouse, father, mother, issue, brother, sister, or employee; a corporation in which the stock holdings of such person and the trust are significant from the viewpoint of voting control, and any employee of such corporation; and a subordinate employee of a corporation in which such person is an executive).

c. Decanting Provision:

1.5 **Consolidation and Division of Trusts.** In addition to the decanting powers granted under Florida Statutes Section 736.04117, the trustee shall have the powers set forth in this paragraph. The trustee may at any time consolidate any trust held under this instrument with any other trust if the beneficiaries of the trusts are the same and the terms of the trusts are substantially similar. Further, the trustee, in the trustee's absolute discretion, may divide a trust (the "initial trust") into two or more separate trusts and may segregate an addition to a trust (the "initial trust") as a separate trust.

4. **INCOME TAX TOGGLE SWITCHES**

To be or not to be a grantor trust.

The most interesting uses of grantor trusts in today's environment continues to be as a positive means of estate tax reduction, or as a means of exchanging assets with a grantor trust without triggering income tax.

In many situations it is advantageous to draft a trust so that the trust has one or more of the characteristics that create a grantor trust. A trust designed in this fashion is often referred to as a "defective grantor trust."

Specifically, the grantor must be okay with the concept that he or she will pay income tax on assets that may or may not be available for use by the grantor. Planners should pay attention to this concern — even if it is flawed on a cash flow basis — because it is perceived as important to most grantors.

For example, a grantor who has a $30 million taxable estate still may not feel that he or she is able to bear the "burden" of income taxes on income not received by the grantor. This conclusion, if not logically grounded on fact, is nevertheless real to the client, and planners need to plan for this reaction. A discussion of cash flow, perhaps accompanied by spreadsheet analysis as to cash flow (to demonstrate the real impact of the burden of paying the income taxes without the accompanying cash flow), may be enough to convince otherwise reluctant clients that the grantor trust is a viable estate tax reduction strategy.

(a) <u>Unified credit, applicable credit amount, gifting trust</u>.

In a straight gifting situation in which the grantor gifts property equal to or in excess of the gift tax exemption equivalent ($11,180,000 in 2018), a gift to a grantor trust is preferable to a gift outright. If the gift is of appreciated assets, the donees will realize the capital gain in the future when the assets are sold. However, if the gift is to a grantor trust in which the grantor retains no interest other than that necessary to make it a grantor trust, then future capital gains will be paid by the grantor instead of the trust. In addition, ordinary income and other taxable income incurred annually can be allocable to the grantor of the trust. This has the effect of increasing the estate-tax-free property in the hands of the donees while decreasing the estate-includible property in the hands of the donor.

(b) <u>Grantor retained annuity trusts (GRATs)</u>

GRATs are grantor trusts masquerading as pure transfer tax strategies. Since the GRAT permits payment of both income and trust principal to satisfy the annuity payments the grantor has retained, the GRAT will be treated as a grantor trust for income tax purposes. This means the grantor is taxed on income and realized gains on trust assets even if these amounts may be greater than the trust's annuity payments. This further enhances this tool's effectiveness as a family wealth-shifting and estate-tax-saving device. In essence, the grantor is effectively allowed to make tax-free gifts of the income taxes that are attributable to assets backing the remainder beneficiary's interest in the trust. Consider establishing the distribution to the remainder beneficiaries as a distribution to grantor trusts for their benefit.

(c) Sale to a grantor trust.

The sale is structured by the owner of the asset, which may be a business interest. He or she initially establishes a trust that is effective as a grantor trust for income tax purposes but that is not controlled by the business owner or otherwise subject to an estate tax taint. The heart of the transaction is a sale between the grantor and a third party — *e.g.,* the grantor's family irrevocable trust. This trust will benefit the grantor's beneficiaries. The adult children are often designated as the original trustees of the trust. As a grantor trust for income tax purposes, there will be no recognition of gain on the sale of the asset to the trust. Thus, the difference between the grantor's basis in the asset and the sales price to the trust will not currently be taxed as a capital gain. Further, the grantor will pay income taxes on the income received by the trust because of the assets the trust owns. In this regard, it is as if for income tax purposes the grantor still owns the assets sold to the trust. Importantly, the payment by the grantor of those taxes will not, under current law, constitute a gift to the trust.

Consider then making irrevocable trusts grantor trusts, with the ability to in effect turn off grantor trust status.

Recommendation Five: In grantor trust planning, consider including the power to substitute. The power to substitute assets, a section 675 (4) grantor trust power, becomes especially important as the estate tax exemption increases and income tax planning becomes more relevant for step up in basis purposes. In many settings, a grantor of a grantor trust may want to substitute high basis assets for low basis assets in a grantor trust, and the substitution power is one way this can be achieved (a purchase agreement is another).

Recommendation Six: Another grantor trust power that is currently used by practitioners is the power in the trustee or other party (who is a non-adverse party) to add charitable beneficiaries. Consider the value of having the power to name charitable beneficiaries in grantor irrevocable trusts. Having the power to name charitable beneficiaries allows for (1) shifts in property from private to non private to reduce amounts going to beneficiaries[2] and (2) disincentives to beneficiaries to challenge trustee actions. Under section 674(b)(5), the ability of a non-adverse party to expand the class of beneficiaries is a grantor trust power.

5. CHANGE OF TRUST SITUS TO MORE FAVORABLE JURISDICTIONS FOR STATE INCOME TAX AND CREDITOR PROTECTION PURPOSES.

This seems to be an easy one, but we should emphasize the importance of this to our clients. Two items: we want to be able to change situs to achieve more favorable administration protection under that state's laws.

And we want to be able to change situs and trustees to take income taxation out of one state and put it in another.

For example, if California imposes trust taxation based, *inter alia*, on trustee residency, we would want our California trustee to have the ability to appoint new trustees.

[2] "Gee, my kids really don't need all that money."

Recommendation Seven: Have both change of situs and trustee designation provisions in the documents, and discuss the BENEFITS to clients, at a follow up estate planning meeting.

1.1 **Controlling Law**. The validity and effect of each trust and the construction of this instrument and of each trust shall be determined in accordance with the laws of Illinois. The original situs and original place of administration of each trust shall also be Illinois, but the situs and place of administration of any trust may be transferred at any time to any place the trustee determines to be for the best interests of the trust.

1.2 **Individual Trustee Succession**. Each acting individual trustee, or the individual trustees acting unanimously if more than one individual trustee is then acting, unless limited in the instrument in which the trustee was designated), may, by signed instrument filed with the trust records, (a) designate one or more individuals or qualified corporations to act with or to succeed the trustee consecutively or concurrently, in any stated combination, and on any stated contingency, and (b) amend or revoke the designation before the designated trustee begins to act. In the event of any conflict or inconsistency between a designation filed pursuant to this paragraph and a designation filed by my spouse pursuant to paragraph 10.4 hereinbelow, the designation filed by my spouse pursuant to paragraph 10.4 hereinbelow shall prevail, and the designation filed pursuant to this paragraph shall lapse to the extent necessary to eliminate the conflict or inconsistency.

6. CREDITOR PROTECTION TRUSTS FOR BENEFICIARIES.

Are lawsuits decreasing or becoming more plentiful, especially plaintiff actions? Although one must be cautious of the representative bias -- seems like there are more lawsuits, but we are only reading about < 1 % of all filed lawsuits, so we really do not know -- but likely there are more lawsuits being filed each year. People are greedy, lawyers are creative, life is more complicated, and people are getting more entitled. All variables to increase the abundance of lawsuits.

If we represent individuals protecting their wealth, they likely want to establish trusts for creditor protection purposes. An interesting development is the distribution of funds to adult, well-to-do children, or, to state it another way, the distribution to adult children who are not spendthrifts. In those instances, there may be no reason to hold funds in trust, at least not for the traditional reason of protecting children against their own self-indulgences. However, creditors, including a child's spouse, lurk in many dark and not so dark corners of the world.

Recommendation Eight: All substantial bequests and gifts should be in a flexible trust format, so that one can argue the creditor protection typically available to third-party created trusts.

Consider discussing with the client the various trustee alternatives to provide a creditor protection shield for funds left in the trust not needed for the child's consumption, as the child determines from time to time. Note the use of the word "shield," versus "insulation." These trusts are intended to balance flexibility for the child in terms of access to the principal, with some protection against creditors, rather than completely insulating.

For planning purposes, assume the client and planner have determined that a flexible creditor protection trust for adult children is desired. Therefore, the question becomes how close to the edge can the trust be pushed. For example, can the child be trustee or a co-trustee? If so, must the standard be a narrow one related to health, support or maintenance? Or should the standard be expanded to "best interests?"[3]

<u>Recommendation Nine</u>: Because powers of withdrawal or general powers of appointment (express) will under case law allow creditors to access that power, eliminate lifetime powers in these trusts for a beneficiary. Instead, make each trust a fully discretionary trust during the life of the beneficiary (child).

The next question is the standard for distribution, as well as the selection of the trustee. The answer is a strange intersection of case law, practitioner bias, and client receptivity.

Ideally, we would like it be someone other than the child, the Generation Two (G2 as has become popular estate planning lexicon. We are a funny group of practitioners).

Most clients want it to be the child.

We know from evolving case law that courts could force a trustee, who is also a beneficiary, to make a discretionary distribution to the beneficiary in order to satisfy a creditor. For example, under the Restatement of Trusts (Third), section 60, paragraph (g), the creditor can reach the "maximum amount the trustee-beneficiary can properly take." In the example under that paragraph, the creditors are able to reach out of the trust, when the beneficiary/debtor is the trustee, "the maximum amount of trust funds that [the debtor] may, without abuse of her discretion, distribute to herself for authorized purposes." The spendthrift provision would not offer a restraint, according to the comment in paragraph (g).

Personally, I like the beneficiary as trustee, with the understanding that the beneficiary could resign as trustee prior to a creditor event occurring, or when the trust is created, the beneficiary (who then has creditor issues or who thinks he or she may) can just decline to act. For those clients with adult G2s, this gives the practitioner the opportunity, if the client consents, to discuss the future planning with those adult children.

But even in this case, a court may look askance at the declination or resignation to act and hold that once that power was available, any actions thereafter taken are ignored. *See, e.g., Bottom, infra* (implying that resigning as trustee would be ignored for purposes of determining the trust's creditor protection).

An alternative would be a co-trustee situation, with the beneficiary having participation rights only as to ascertainable distribution decisions, and the co-trustee having rights as to discretionary distributions for "welfare or best interests." *See, e.g., In re Schwan*, 240 B.R 754 (Minn 1999) (holding trust protected from creditors because of co-trustee and because of fiduciary duties to follow terms of trust and distribution standards). *See also McCauley v. Hersloff*, 147 B.R. 262 (M.D. Fla 1992) (Discretion to make a distribution rested in multiple trustees, of which the beneficiary was only one; therefore, spendthrift protection valid. "Moreover, in exercising that discretion each trustee has a fiduciary obligation to the remaining beneficiaries"); Restatement of Trusts (Third), section 60 (no forcing of distributions if the

[3] "Best interests" is a scary standard for trusts controlled by beneficiaries for tax purposes, but perhaps not for creditor protection purposes.

beneficiary is merely a co-trustee, and the other co-trustee has fiduciary obligations to other beneficiaries, which would almost always be the case).

7. IS GST PLANNING REALLY GOOD PLANNING?

We like to save estate taxes and leave as much money as we can for our clients' beneficiaries. Fun, rational, correct.

But is money to beneficiaries always a good thing? We know "no." Money left to individuals can result in lethargy, bad behaviors, and bad lives.

We can address it by allowing third parties with broad limited powers of appointment to appoint to charities. Second, we really do need to consider the value of "dynastic" trusts. The creator of trusts rarely know their great grandchildren, so why are trusts being set up to leave substantial funds to those distant generations?

Recommendation Ten: Make sure each generation has a testamentary power of appointment, broader than to just descendants. Consider adding trust protectors to allow change in the terms of trusts.

8. "I AM A CHILD, I LAST AWHILE," Neil Young, circa 1968.

The definition of "child" no longer lasts awhile. Genetic manipulation and choice will occur. Birth mothers, perhaps laboratory mothers, may become more prevalent. We will have to tweak what we mean by "child." We may want to expand the definition of "child."

The following provision, regarded as "state of the art" about 10 years ago, is already outdated. Can you spot the anachronisms?[4]

> 1.1 **Child and Descendant.**
>
> (a) **Child**. A "child" of a person means only: (1) a child born to or conceived by the natural mother of the child during the lawful marriage or civil union of the person to the natural mother, unless paternity is rebutted by clear and convincing evidence; (2) a child born to a gestational surrogate engaged by that person or, if the person is then lawfully married or a party to a civil union, engaged by that person's spouse or partner by civil union; (3) a child lawfully adopted by the person prior to that child's attaining age 18; and (4) a natural child of the person, if the person's parental rights have not been terminated and either (i) the person is female or (ii) the person is male and the trustee has been provided legally sufficient evidence of the person's paternity or the person has acknowledged paternity in a signed writing.
>
> (b) **Descendant**. A child of a person is a "descendant" of that person and of all ancestors of that person. A person's descendants include all such descendants whenever born. Except when distribution or allocation is directed to descendants *per stirpes*, the word "descendants" includes descendants of every degree whether or not a parent or more remote ancestor of a descendant is also living.

[4] E.g., "maternal", "paternal", "natural child", "females", and so on. Are these terms clear enough anymore?

(c) **Child in Gestation**. A child in gestation on the date any allocation or distribution is to be made shall be deemed to be living on that date if the child is subsequently born alive and lives for at least 90 days.

9. **STABILITY**

The world is becoming a much smaller place. Will our clients' descendants continue to be US Citizens? Is their security in place? What kind of food considerations will be more relevant in the future. All things considered, we in the United States are doing quite well, but what will it be in fifty years?

Recommendation Eleven: Trustee guidance could consider distribution of funds to allow beneficiaries to move to jurisdictions outside of the United States, to allow distributions for security measures for beneficiaries, and also to consider distributions needed to modify food/food production. Can we think of any other? I suspect yes.

Conclusion: The world is not static, and our estate planning practice should not be either. As we continue to hone our techniques, attorneys should continue to expand on flexibility and creativity in our planning.

The following outline was adapted from a 2017 presentation at the Heckerling Institute on Estate Planning

It has been partially updated for changes in the law brought by the Jobs Act of 2017. But as a caveat, many of the examples use lower and prior estate tax exemption rates

" The Estate Planning Times, They Are a Changin'. Where's my Nobel Prize?"

If you forgive the cutesy aphorisms or sayings here, the attached are the subject titles of important concepts from this week (planning techniques and practice styles) that we will be discussing this morning (and are discussed in the materials).

They provide the blueprint for certain actions for us as planners to take in 2018 and beyond. And hence go by the name of "take(aways)."

Takeaway #1: Captaining Your Estate Planning Ship so You are not Captaining the Titanic

Every new matter, and every project should be mentally charted on the above graph. In addition to avoiding clients that should be avoided, we all know that, avoid projects that would fall within the lower left hand corner of this chart.

Takeaway #2: Do You Love Me Matters.

Quadrant (b) is better to be in than Quadrant (c). Know why.

Takeaway #3: "Hi, it's me."

As technology tentacles out and suffocates our free time, we are often focused on strategies on how to use it less. Continue to focus on that process. But also continue to recognize the amazing communication availability and value to clients that technology offers, and do not be timid to use it for "personal" touches to your clients.

Takeaway# 4: Sometimes a soft single is better than a rocket line drive right to the mitt of the left fielder.

Because the Service has clarified the inapplicability of Revenue Procedure 2001-38, the better part of valor may be the single fund QTIP trust, accompanied by a long cover letter explaining the multiple trusts that will be created. One will have happier clients (quadrants (b) and (a)) with this approach.

Takeaway #5: Who says status quo is a bad result.

With portability, the absolute funding requirement for each spouse to have $11.180m is reduced. Now the practitioner can focus a bit more on the effects of divorce on a change of titling, and perhaps not shift title as often as we used to have to.

Takeaway #6: The world is Orwellian.

When it comes to possible Service review, practitioners should assume that there is a camera in the corner of the planning room. Whether one is monitoring the tapes on the camera is an open question.

Takeaway #7: "Wisdom is knowing the limits of one's ability."

I once knew a practitioner who was so careful in his estate planning that to this day, I am convinced there were no mistakes in his planning. Notice how I said "a" practitioner. I have known no others. And this one wrote off 80% of his time.

Takeaway #8: Not Risky Business.

Rhetorical question: go back to charts #1 and #2: where in the charts is trustee administration by a trusted, knowledgeable, out of the box thinking, confidante (the "practitioner"), in terms of perceived value added and risk to the practitioner?

Takeaway #9: Do Not Miss the Valuation Forest because of Stunted Discount Trees.

Planning with discounts for operating and commercial enterprises is still viable and important no matter what happens with the proposed regulations.

Takeaway #10: "I'm Not Dead Yet."

Partnership marketability and minority discounts for family entities, including family limited partnerships, are still in effect until these regulations are finalized. Consider GRAT planning and sales of discounted assets for those clients who are transfer tax motivated. But also factor in income tax planning.

Takeaway #11: Stupid is as Stupid Does.

We have to be cognizant of income tax planning when it comes to discounted family partnerships, especially those funded with marketable securities. Long before the proposed 2704 regulations, the marketable asset partnership for estate tax purposes became a strategy of excessive effort/limited value. The possible tax savings would be marginal estate tax rate (40 %) -loss of basis step up * rate (cumulative, about 30%) * Potential discount (35 %), or 3.5 % of the value of the decedent's interest in the partnership. Only if the basis was not lost (via a lifetime transfer), could the strategy make sense.

Takeaways #12: Math For Dummies/Lawyers.

Used to be we could just practice law and occasionally argue about the level of minority or marketability discount. The reality now is that we have to be versant with the ins and outs of valuation methodologies. "There's gold in them there hills," is one way to look at it.

Takeaway #13: The Moral of the story.

The moral of the story: invest in volatility (or assets with a high discount rate in valuation versus before cash flow generated) within the GRAT to the extent the grantor would ordinarily be invested in those types of assets. In a worst case scenario, the GRAT yields no transfer tax savings because there has been no increase in value. However, in other scenarios, substantial transfers will have occurred.

Takeaway #14: The tide comes in/the tide goes out.

The tide has come in for GRAT planning as an estate planners first sophisticated planning strategy of choice. Structuring advanced estate tax strategies with GRATs should be considered because of the statutory authorization and ability to reduce readjustment risk as to valuation, and because of the extreme discrepancy (transfer tax arbitrage) between the required use of the risk free section 7520 rate in valuing GRATs, and the return or volatility rate of the underlying GRAT investments. We should embrace creativity when we think about the possibilities for this statutorily authorized transfer tax technique.

I. Looking Forward

The American Taxpayer Relief Act of 2012 (the "2012 Act"), and its 2017 Brethren, the Tax Cuts and Jobs Act of 2017, has had major impacts on our practice as estate planners.

In addition, technology has revolutionized the mode by which we impart our intellectual judgment and wisdom to our clients. Our planning clocks have turned 180 degrees from where we used to be 30 years ago.

The purpose of this segment is to highlight both THE STATE OF MIND and practical strategies that we need in our estate planning practices.

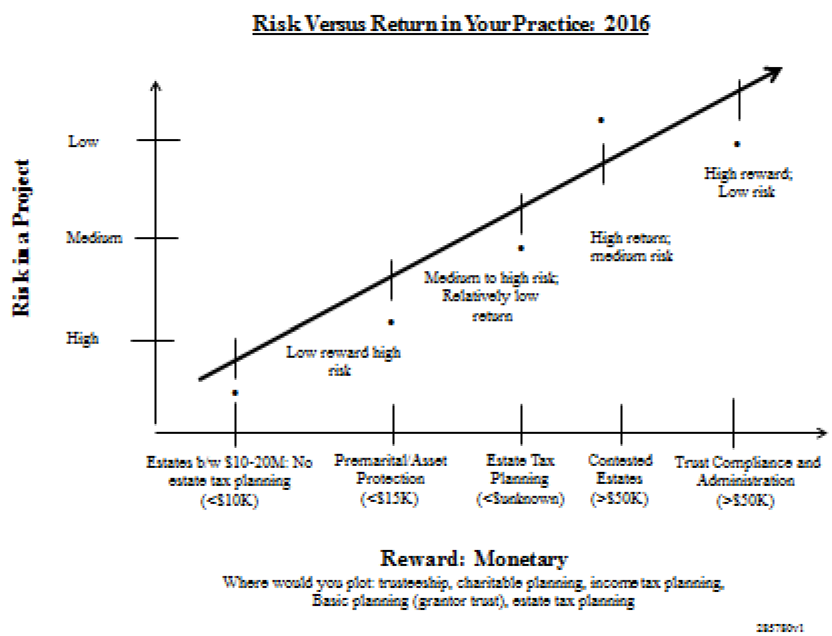
We start with technology (sections II through IV), and then move on to planning.

II. Risk Assessment

Technology has resulted in speed, increased expectations, greater risk, and a change in the way we should look at our practices.

When we engage in estate planning, we are entering the intellectual coal mine each day. We need to be cognizant of that to make sure the canary does not find itself on its back as a result of any particular strategy.

A. Imprint this on Your Mind



Confusion

Be careful to understand the distinction between intellectual stimulation (ego?) and mercenary pragmatism (reward?), and to consider the influence of each on your financial well being versus defendant status in a lawsuit.

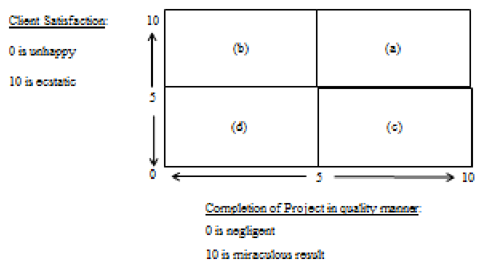
B. **Takeaway #1**: Captaining Your Estate Planning Ship so You are not Captaining the Titanic

Every new matter, and every project should be mentally charted on the above graph. In addition to avoiding clients that should be avoided, we all know that, avoid projects that would fall within the lower left hand corner of this chart.

III. <u>True Client Appreciation</u>

A. <u>Accomplishments.</u> We need to differentiate from what we value as accomplishments from what the clients value as our accomplishments.

MATRIX OF REAL ENDGAME



1. (a): Continuation of relationship. Minimal risk. Has a premium been built into fee?
2. (b): Continuation of relationship. Minimal risk.
3. (c): Termination of relationship. Risk.
4. (d) Lawsuit potential and remedial action.

B. **<u>Takeaway #2</u>**: Do You Love Me Matters.

Quadrant (b) is better to be in than Quadrant (c). Know why.

IV. <u>Use Technology to Make Clients Happy</u>

A. <u>It's Not All Bad</u>.

Used effectively,[1] technology generally, and the email and text system specifically, can achieve the following:

1. Increase speed in communications and efficiently conveying ideas (organizing a football game among a group of people, for example; setting up a conference call). *Leads to getting projects done faster, making clients happier, and decreasing malpractice exposure*.

2. Efficiency in communication: no pregnant pauses, or stops to say "how you doing?" *Encourages follow up to clients*.

3. Comfort—easy to use, type and send. *Encourages legal work*.

4. Time shifting-you can communicate whenever and at weird hours. *Allows you to work on client projects more often*. Be conversant with the Delay Delivery Option (discussed below)

5. Facilitate projects by give and take and immediate answers to significant and insignificant questions. *Allows projects to be completed quicker*.

6. Overall, increase client happiness.

B. <u>But Beware the TSA Aspects</u>

[1] Work Objective: Profitability. Ask yourself, how is email making me more profitable? If email could allow us to (1) communicate better, (2) get projects done quicker, (3) get answers easier, (4) manage projects, or (5) manage colleagues, these are all good objectives.

Used ineffectively, email can be a TSA (time sucking abyss) that constantly annoys. Do we really need to get texts and emails during dinner? Do we have enough focus during the day on substantive projects? Are we being interrupted during our drafting, telephone conferences, in person meetings, in office meetings, by the email?

Too many emails can actually confuse a project – who is doing what, what stage the project is in, or create a substantive confusion.

Assume you charge by the hour. Your first foray into the analysis is to be honest about how much email costs you per day. Example, if you do not charge for email, and you spend 2 hours on it, isn't it costing you 2 hours?

C. **Takeaway #3**: "Hi, it's me."

As technology tentacles out and suffocates our free time, we are often focused on strategies on how to use it less. Continue to focus on that process. But also continue to recognize the amazing communication availability and value to clients that technology offers, and do not be timid to use it for "personal" touches to your clients.

V. The American Taxpayer Relief Act of 2012

Three changes brought out by the 2012 Act, and the Tax Cuts and Jobs Act of 2017 -- an increase in the estate and gift tax exemption to what is in 2018 an indexed $11.180 million amount, a highest marginal estate tax rate of 40%, and the advent of portability – have affected most tax aspects of the planner's practice, directly or indirectly.

Certain planning strategies discussed this week, which we will reference in the presentation, highlight these changes and their impact on the practice going forward, including:

A. Type of estate tax plans and how to draft for them.

B. Advocacy of changing title between spouses.

C. Internal Revenue Service reviews.

D. Commodization.

E. Malpractice.

F. Future of discounts, and of family limited partnerships.

G. Grantor retained annuity trusts.

VI. The World of Estate Planning Drafting: 2018 and Beyond

The increase in the exemption to what is now 11.180 million dollars means that the federal exemption is, in certain states, higher than the state exemption. This requires the introduction of a new trust in estate plans, a federally exempt trust that may be state QTIP, if allowed. For example, in Illinois, the state exemption is 4.0 million dollars. This means an estate plan for say a couple with 13.180 million dollars in the first spouse to pass away, could have the following trusts: a 4.0 million state and federal exemption trust, a 7.180 million dollars federal exemption trust that qualifies for state QTIP, and the balance (2 million dollars) outright or in a federal QTIP trust for surviving spouse.

Further, with the advent of portability, no longer is it absolutely certain that a credit shelter trust should be created. Therefore, the estate plan needs to be drafted to potentially accommodate the credit shelter trust being included in the surviving spouse's passing, allowing portability if the decision is then made at the first spouse's passing to elect portability.

A. Types of planning done for clients.

Because of the multiple trusts that must be created, per the discussion in above, the drafting has become complicated. The Treasury, in Revenue Procedure 2016-49 has clarified that QTIP elections can be made for portability purposes, even if no tax deferral is required, and then a single fund QTIP trust may be the drafting of choice.

Assuming the Treasury allows for this result, the single-fund QTIP allows a practitioner to achieve the following for his client:

6. For the portability decision to be decided at the surviving spouse's passing. Estates may want to include 100 percent of the property in the surviving spouse's estate to achieve a step-up in income tax basis. The goal will be either to make a partial QTIP election to create a credit shelter trust out of the non-elected portion (the $11.180 million estate tax exclusion amount) or a full QTIP election to put all the property in the surviving spouse's estate for basis step-up reasons.
7. For state inheritance tax to be avoidable at the first spouse's passing if that state has a QTIP marital deduction, even if that state has a credit that's decoupled from the federal credit.
8. Ease in drafting.[2]
9. Ease in client understanding.
10. Ease in administration until multiple trusts are created (post-mortem).

B. **Takeaway# 4**: Sometimes a soft single is better than a rocket line drive right to the mitt of the left fielder.

Because the Service has now clarified the inapplicability of Revenue Procedure 2001-38, the better part of valor may be the single fund QTIP trust, accompanied by a long cover letter explaining the multiple trusts that will be created. One will have happier clients (quadrants (b) and (a) with this approach.

VII. Advocacy of changing title between spouses

Since 1982, planners have had to discuss with spouses the need to shift assets to the non-propertied spouse to allow for that spouse to have assets to fund the credit shelter trust, in the event that spouse predeceased the other. With portability, that shifting of assets is no longer necessitated to protect use of the exemption. Because of concerns over how a shift in title may affect property rights on divorce, this area of discussion becomes more difficult. Perhaps asset transfers to allow credit shelter funding will be ignored by planners.

A. Funding of the Credit Shelter Trust

Percolating out there in estate planning since 1984 has been the concern about retitling assets to allow the funding of the credit shelter trust at the first spouse's passing. With the estate tax exclusion reaching $600,000 in 1984, planning often required a retitling of assets from one spouse to another to ensure that when the first spouse passed away, there would be sufficient assets to fund that spouse's credit shelter trust.

Example: Circa 1984, husband had assets consisting of a $600,000 house, an IRA of $1,000,000 and marketable assets of $800,000. Wife had no assets in her name. During the estate planning discussion, the planner recommended that either the house or a portion of the marketable assets be

[2] For those of us who enjoy drafting, we know what the 3 trust plan looks like, with a state exempt, a federal exempt, and a federal QTIP trust all being in place. Throw in there a mismatch of remaining GST exemption from the unified credit, and we have a couple more trusts being called for. The client does not have a chance of recognizing the planning; and the drafter has a strong chance of, ummm, poor drafting if he or she hasn't done a lot of these. All these problems are eliminated with a single fund trust.

titled in the wife's name, to ensure that wife's $600,000 credit shelter trust was funded in the event she was the first spouse to pass away.

The often glossed-over concern was whether the change in title of assets, from husband to wife in the above, affected the marital/non marital nature of the property for divorce purposes. Given the importance of avoiding estate taxes and the justification for doing so pre-portability, that marital concern often took a back seat to the actual need to reallocate for estate tax purposes.

B. Portability

Portability – the concept of allowing the surviving spouse to inherit the deceased spouse's estate tax exclusion -decreases the necessity of reallocating assets as between spouses to maximize the use of the estate tax exclusion. A determination of whether to rely on portability is itself a sophisticated analysis, but now the marital/non marital concerns related to asset transfers between spouses needs to be considered further because no longer is it a necessity to transfer assets to ensure full use of the estate tax exclusion.

C. Titling

Titling is possession. And possession is nine tenths of the law, but not one hundred percent. And, titling does not in and of itself determine whether property is marital or non-marital.[3]

Example: During marriage, wife is the sole breadwinner, and titles all earnings in her own name. Despite owning all assets, these assets are marital because they were earned in the traditional sense (not from separate assets) during marriage.

The issue that needs to be examined, however, is whether a change in titling transmogrifies — in the marital sense, "transmutes"— the nature of the property from one classification to another.[4]

Example: If husband brings into the marriage $1,000,000 of separate assets, and during the marriage gifts those assets to his wife, has that gift changed the nature of the property from the husband's separate property to the wife's separate property? Yes, if the husband intends to make this distinction via the gift, possibly no, if the intent is merely to change title for estate planning purposes (discussed below).

D. Linked Together by Marriage, but My Assets Remain Mine

A majority of the states have adopted a dual approach to classifying property as either 'marital property' or 'non-marital property'.[5] Property classified as marital property is property that both spouses are entitled to share in the event of divorce. Property that is classified as non-marital is

[3] The title system to determining property in divorce has been changed by state equitable distribution statutes. *See, e.g.*, Morgan, "When Title Matters: Transmutation and Joint Title Gift Presumptions" 18 Journal on Matrimonial Lawyers 33 (2003). Title has theoretically become rendered inconsequential.

[4] A transmutation is a transfer of property between spouses whereby the characterization of the property changes as a result of the transfer.

[5] The "dual classification" states which classify property as marital or separate are: Alabama, Alaska, Arkansas, Colorado, Delaware, District of Columbia, Florida, Georgia, Illinois, Iowa, Kansas, Kentucky, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, New Jersey, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, Utah, Virginia, West Virginia, and Wisconsin. In the remainder of the equitable distribution states, all property, however and whenever derived, is subject to equitable distribution. The "hotchpot" states which provide that all property is subject to division are: Connecticut, Hawaii, Indiana, Massachusetts, Montana, Nebraska, New Hampshire, North Dakota, Oregon, Rhode Island, South Dakota, Vermont, and Wyoming.

awarded to the owner-spouse.[6]

With spouses retitling their non-marital assets between themselves, and titling property in joint ownership, the character and identity of non-marital assets has become far more difficult to classify, and thereby more difficult to preserve. In marital property states,[7] the problem can be illustrated by the transfer of property to a species of trust known as the "joint trust."

Particularly complicated (or seemingly so) is the analysis of whether non-marital property transferred to a joint trust results in the property losing its character as non-marital property. In the joint-trust context, consider the argument if one spouse's property is transferred to a joint trust and falls under the control of the other spouse's unilateral withdrawal right.

Example: Spouse 1 contributes 90% of their individual property, and spouse 2 contributes 10% of their individual property to a joint trust. Each spouse has the unilateral right to terminate the trust and withdraw an equal share of the property. On termination all property is returned to the spouses as tenants in common. Because each spouse exercises their equal and unilateral right to terminate, spouse 1 has arguably made a 40% gift to spouse 2 (90% initially contributed less 50% retained if trust is terminated). As to this 40%, if the property was spouse 1's individual, non-marital property prior to transfer, has it now has become the non-marital property of spouse 2 because of withdrawal right? Or, alternatively, does this property become marital property to be divided equally at the termination of the trust because it was titled jointly and became a gift to the marriage? But the mere transfer to a joint trust is ambiguous as to result.

E. <u>To Achieve Transmutation</u>

In making the determination as between marital or non-marital property, a court may apply a presumption that the title of the property is how the property should be classified; marital property (joint) or non-marital property (separate). When title has changed from one estate to another, the courts will review whether the parties **<u>intended</u>** to make a gift from the one estate to the other, thereby transmuting from one classification to another.[8]

Therefore, a change in title from (i) one spouse to both spouses jointly, from (ii) both spouses to one spouse, from (iii) one spouse to the other spouse, or from (iv) both spouses jointly to one spouse, will at a minimum garner scrutiny on property division in divorce.

Consider then a separate document, signed by each of the parties, indicating that transfers to the joint trust (or from one spouse to another) are being done exclusively for estate planning purposes; and are <u>not</u> intended to transmute the property, and that the character of property remains as prior to the transfer.[9]

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[6] The courts often find 'equitable' methodologies as an end around, such as awarding alimony, requiring reimbursement, and applying various equitable doctrines, such as marital energies doctrine; that the effort of one spouse helped enhance the value of the non-marital property of the other spouse. Non-marital assets are generally defined as property acquired before the marriage, or by gift or inheritance, or are protected under the terms of a valid agreement between the parties.

[7] Meaning non-community property states.

[8] In certain states, the law presumes that when individual, non-marital property is transferred into the joint names of both spouses, the property has been gifted to the marital estate. Extrapolating to a joint trust (not exactly the same as a joint name), one could argue that the transfer of non marital property to a joint trust may also invoke this presumption. But because it is a presumption, that can be overcome by an intent by the parties to treat it otherwise.

[9] The best evidence a spouse could have to rebut the joint title gift presumption is a written instrument signed by both parties with an express provision stating that no gift is intended. Burnside v. Burnside, 460 S.E.2d 264, 273 (W. Va. 1995). See also Connealy v. Connealy, 578 N.W.2d 912 (Neb. Ct. App. 1998) (an unsigned prenuptial

More specifically, consider the following steps:

Step one: Know the state law to understand if there are any quirks in the state law that should be taken into account in drafting the Intent Agreement.

Step two: The parties, both represented by the same counsel, sign an agreement that all transfers between spouses are being done exclusively for estate planning purposes, and are not intended to transmute the property, and that the character of property remains as prior to the transfer.[10]

Step three: Optional: Have the parties acknowledge in the agreement that the practitioner is representing both parties, and the parties consent to that representation, that the agreement may not be effective under state law to protect against transmutation, and that the parties nevertheless intend for this document to prevent transmutation, to every degree possible.[11]

Step four: Effectuate the transfer but make sure the parties know to monitor the assets and reinvestments thereof. The parties should invoke tracing principles, because if a court can't identify their separate assets and they have lost their character because they cannot be traced or identified, the court may characterize the assets as marital property.

And the downsides of this approach?

F. Agreement Signed-the 50 % Solution (no Divorce)

When the property is transferred to one's spouse for estate planning purposes, either to fund a credit shelter trust (ignoring the viability of portability), or perhaps to achieve a step-up in basis (a low basis, for example, a basis asset is transferred shortly before death, at least a year), and the Agreement not to transmute or change the character of the property has been signed, can we sleep at night? Here, then, are the questions for the practitioner:

1. Will this be respected for contract purposes?

At least two concerns here: Is there a contract, and is the contract in the nature of a post marital agreement? If this is a post-nuptial agreement, there has been no separate representation and no disclosure of assets, and the agreement would seem to be voidable.

There is certainly consideration as between husband and wife for the agreement. One example of consideration is that the property will not be transferred until the agreement is signed.

A post-nuptial agreement would seem to require one spouse giving up or modifying a marital right. In this setting, there are no marital rights being given up. That is, if the wife has separate property, and transfers title to the husband, but both wife and husband agree that it shall retain its character as wife's separate property, husband is not giving up any marital

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agreement was evidence of the husband's lack of donative intent); Parkinson v. Parkinson, 744 N.Y.S.2d 101 (N.Y. App. Div. 2002) (a document signed by both parties, though not meeting requirements of an enforceable contract, was sufficient to show evidence of intent).

[10] The best evidence a spouse could have to rebut the gift presumption is a written instrument signed by both parties with an express provision stating that no gift is intended. Burnside v. Burnside, 460 S.E.2d 264, 273 (W. Va. 1995). See also Connealy v. Connealy, 578 N.W.2d 912 (Neb. Ct. App. 1998) (an unsigned prenuptial agreement was evidence of the husband's lack of donative intent); Parkinson v. Parkinson, 744 N.Y.S.2d 101 (N.Y. App. Div. 2002) (a document signed by both parties, though not meeting requirements of an enforceable contract, was sufficient to show evidence of intent).

[11] Not in Appendix A Agreement.

rights. The husband's rights to this separate property after the transaction are the same as before the transaction. One could argue that this is not in the nature of, or covered by, post or other nuptial statutes or agreements. Therefore, adherence to the formalities of a post-nuptial agreement would not be required. That is my argument. Each state's statutes would need to be reviewed to see if this argument has merit.

2. Conflicts of Interest

Can you represent husband and wife in this setting? I would think the answer is consistent with the answer above, that no property interest is changing its nature, so no spouse is disadvantaged by the transaction; and certainly not the donee spouse of the change of title.

3. 2036 Retained Interest Concerns

A question was raised whether the agreement represents a retained right under Section 2036 (a)(1) or (a)(2).[12] This seems intellectually pure, but pragmatically far-fetched. The retained interest is the right to get the property back in the event of a divorce, as non marital property.

Much like the employment area, obtaining a divorce is an action of independent significance. The Courts have held in the employment setting, property rights that occur at termination of employment are not deemed owned in the 2036 sense because the employee must first quit his or her job, an action of independent significance. The same analysis would seem to apply in a divorce setting, if it were ever raised.

G. **Takeaway #5**: Who says status quo is a bad result.

With portability, the absolute funding requirement for each spouse to have $11.180m is reduced. Now the practitioner can focus a bit more on the effects of divorce on a change of titling, and perhaps not shift title as often as we used to have to.

VIII. Internal Revenue Service Reviews

As planners, we used to assume that the Service would not review many gift tax returns and that often estate tax returns would, likewise, go unreviewed. For example, there were only so many agents, and only so much time to review the number of returns that were being filed. Anecdotally, based on statistics presented at recent conferences, that non review (1 % of gift tax returns, for example) is continuing.

But mathematically, that result truly cannot be occurring. With the exemption now protecting married couples with assets totaling less than about 22 million dollars, the number of estate tax returns filed have likely decreased by over 80 %. Therefore, we have to expect that more returns will be audited on a percentage basis. And based on the experiences reported by practitioners, the results support that conclusion: almost all estate tax returns are being reviewed in more detail, many resulting in some level of audit, and a greater number of gift tax returns are being reviewed. The level of practitioner effort that goes into these returns, which always should have been substantial, should continue. And the practitioner should recognize that returns have a great chance of being reviewed.

Takeaway #6: The world is Orwellian.

[12] This issue is so far off the radar screen of possibilities, that it would only be raised by one with a bit too much theoretical time on their hand.

When it comes to possible Service review, practitioners should assume that there is a camera in the corner of the planning room. Whether one is monitoring the tapes on the camera is an open question.

IX. Malpractice

As a result of increased Service review, the malpractice risk is also increasing. When it comes to possible Service review, practitioners should assume that there is a camera in the corner of the planning room. Whether it is monitoring the types on the camera is an open question. This occurs in multiple ways.

First, planning that was done unsuccessfully before may not have been reviewed, and therefore would have been successful in effect. That same planning may now be challenged and defeated.

Second, even planning that is done right, but nevertheless challenged by the Service, is often subject to client second guessing. Recent lawsuits against planners who have had their estate tax planning challenged by the Service, support that conclusion.

Third, with the increased exemption and portability, clients that had estate tax planning in the 90s and early 00's, may no longer need it; but could avail themselves of increased basis step ups if there is full inclusion. Have all estate plans been reviewed to shift from an estate tax exclusion trust to a basis step up trust?

Takeaway #7: "Wisdom is knowing the limits of one's ability."[13]

I once knew a practitioner who was so careful in his estate planning that to this day, I am convinced there were no mistakes in his planning. Notice how I said "a" practitioner. I have known no others. And this one wrote off 80% of his time.

We are bored, focused, unfocused, careful, sloppy, and faced with a host of other practice paradoxes. Mistakes will be made. Limiting malpractice exposure requires two foci: keep up the communications with clients-see section II; and focus your practice in quadrants (a) and (b).

X. Commodization, and or Development of new practice areas

Also emanating from the increase in the exemption amount, there are fewer reasons to draft estate tax plans. Anywhere from 50 to 80 % of estate planners' prior tax planning estate plans have now been rendered obsolete. Therefore, less estate tax drafting and planning is occurring. Clients will often perceive the drafting process as one in which the least amount of effort and time and cost should be spent. Since a client may perceive no estate tax advantages to their documents, they may have less of a desire to pay for drafting. And replication of non-tax forms becomes easier for third parties, lawyers and non lawyers (Legal Zoom for example) who may want to provide "forms at a cost."

Further, with the complication associated with advanced estate tax planning, and the possibility of estate tax repeal, fewer practitioners are well versed in that advanced level of planning. Therefore, estate planners have been shifting to other areas of practice, to replace the lost work on the estate tax planning front.

With less work on the estate tax planning side in estate planning documents, the drafting of documents has continued to evolve as a commodity.

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[13] Wallace Stegner, Angle of Repose.

A. Creditor Protection Trusts for Adult Children.

Typical trust structuring in the 1950s through 1980s for adult children focused on spendthrift trusts, as needed, special needs trusts, as needed, and staggered withdrawal rights for most adult children.[14]

Going somewhat unnoticed, the creative expansion of these boundaries in the last 20 years has been well perceived by clients, and operationally effective when administered.

This creative expansion focuses on the need for testamentary trusts for adult children to be protected from spousal claims, protected from other creditor claims, and not always accessible. In this world today, clients understand the theme that "too much money can pollute," and are receptive to trusts that prevent that from happening. The structuring of these types of trusts, receptivity of clients to these ideas, and results in administration, will all be explored during this presentation.

1. The Genesis of an Appreciated Strategy.

An interesting development is the distribution of funds to adult, well-to-do children, or, to state it another way, the distribution to adult children who are not spendthrifts. In those instances, there may be no reason to hold funds in trust, at least not for the traditional reason to protect children against their own self-indulgence. However, creditors, including a child's spouse, lurk in many dark and not so dark corners of the world.

2. Drafting Creditor "Shield" Trusts.

Consider discussing with the client the use of trusts for the children, with the children as their own trustee, to provide a creditor protection shield for funds left in the trust not needed for the child's consumption, as the child determines from time to time. Note the use of the word "shield," versus "insulation." These trusts are intended to balance flexibility to the child in terms of access to the principal, with some protection against creditors, although not a complete insulation.

During the presentation, we will discuss the client receptivity to this kind of trust and how important these concepts are in the context of estate planning for each and every one of your clients.

3. How to Structure.

For planning purposes, assume the client and planner has determined that a flexible creditor protection trust for adult children is desired. Therefore, the question becomes how close to the edge can the trust be pushed. For example, can the child be trustee? If so, must the standard be a narrow one related to health, support or maintenance? Or should the standard be expanded to "best interests?"[15] Each shift in adding more control to the beneficiary – as trustee, and then pursuant to an unascertainable standard—creates some decrease in creditor protection. How much will depend on evolving state law in this regard. And yet, this is the kind of decision that a client cannot be expected to make in an informed way. The practitioner, based on state law and knowledge of the client's family, has to recommend the format that should be used.

Drafting Example: (The Adult Creditor Shield Trust)

[14] For example, 1/3 at age 25, 1/3 at age 30, and 1/3 at age 35.

[15] "Best interests" is a scary standard for trusts controlled by beneficiaries for tax purposes, but perhaps not for creditor protection purposes.

Child's Separate Trust

Any trust property allocated for a child of mine subject to the Child's Separate Trust withholding provisions shall be added to or used to fund the principal of a Child's Separate Trust for the child. The trustee shall administer each Child's Separate Trust as follows:

Section 1.01 Discretionary Payments of Income and Principal. During the child's lifetime, the trustee may pay to the child so much of the income and principal as the trustee from time to time considers necessary for the health, education, support, maintenance in reasonable comfort, welfare, or best interests of the child. Any income not so paid in each tax year shall be added to principal at the end of each tax year.

Section 1.02 Power of Appointment at Death. On the death of the child, the trustee shall distribute the principal to any one or more persons or organizations (including the child's estate) as the child appoints by Will, specifically referring to this power of appointment.

Section 1.03 Distribution on Termination. On the death of the child, the trustee shall distribute the Child's Separate Trust not otherwise effectively appointed as follows:

(a) Any Descendant Living. If the child has any descendant then living, to the child's then living descendants, <u>per stirpes</u>; or,

(b) No Descendant Living. If the child has no descendant then living but I have any descendant then living, to the trustee to allocate in shares of equal value for my then living children, subject to the Child's Separate Trust withholding provisions hereof; provided that if a child of mine is not then living but a descendant of the child is then living, the trustee shall distribute the share that would have been allocated for the child, if living, <u>per stirpes</u> to the child's then living descendants.

4. <u>Cutting Back the Creditor Protection Trust to a Creditor "Annoyance" Trust</u>

Further, be sure to coordinate the trustee provision so that a child at a certain age can get control over this creditor protection trust, in the child's capacity as a fiduciary.

<u>Drafting Example: Child as Trustee of Creditor Annoyance Trust</u>

Section 1.04 Trustee of Child's Separate Trust. Notwithstanding any other provision, upon attaining age thirty (30), each child of mine shall have the following powers with respect to the Child's Separate Trust established for the child's benefit under this instrument:

(i) Sole Trustee. The child shall have the right to appoint himself or herself as trustee.

(ii) Remove and Appoint. The child may remove any trustee at any time by a signed instrument, but only if, on or before the effective date of removal, a successor trustee has been appointed by that child or at least one trustee will continue to act after the removal.

B. <u>Quarterbacking the Trust</u>

As our traditional estate planning practice gets eroded by risk and technology, as well as changes in the federal tax laws, practitioners need to continue to use their talents in related fields. Often times, clients will request their long standing attorney to be trustee.

1. <u>Administration: a Bridge too Far?</u>

As estate planners, we often focus on our role as strategists, planners that set up a workable estate plan. Examples include establishing a family limited partnership to achieve estate tax discounts, or creation of one or more trusts for estate tax reduction, or establishment of a trust for creditor or spousal protection.

Once techniques are implemented, both planners and clients often experience a certain laissez faire towards the steps post signing, the actual administration of these strategies. In 2017, we should not lose sight of the parallel importance of proper trust administration.

2. What kind of tax animal is this trust?

Step one then is to revisit what type of income taxation the trust is, and to coordinate filing accordingly. For example, all qualified personal residence trusts (QPRTs) and grantor retained annuity trusts (GRATs), are grantor trusts during the retained term. Further, in sales to trusts, typically the trust is a (defective or effective, depending on your bent) grantor trust. At the end of retained terms in QPRTs and GRATs, the successor trusts may be structured as grantor trusts; and gifting trusts may also be grantor trusts.

Revocable living trusts are grantor trusts during the lifetime of the grantor, and post mortem, are usually simple or complex (non grantor in either variety) trusts.

If the practitioner determines a lifetime trust is a grantor trust, the next step is to make sure the accounts are set up with the grantor's social security number[16] and that the grantor's tax compliance professional, typically the accountant, is notified of the trust and that income of the trust will flow to the grantor's 1040. The accountant should also be ready to file a grantor trust information return for the trust.[17]

No other tax planning is required for the trust, other than focus on when to recognize taxable gains, and whether to do substitution. [See discussion below on "Adding Value through Tax Planning."]

If the trust is a non grantor trust, then compliance needs to be done immediately. [18]These include lifetime gifting trusts that are non-grantor trusts, and typically testamentary trusts, trusts created under estate planning documents that come into play at a grantor's passing.

These trusts require the following steps for administration: step one, apply for an EIN, and make sure the accounts are registered accordingly. Step two, determine who will file the income tax returns on an annual basis. Step 3: consider immediately the need for estimated tax payments. Some trusts may not, like grantor trusts that become non grantor trusts at death, have a 2 year window before estimated taxes are required. Step 4: docket December 1 each year for income tax planning, and determining whether the trust or the beneficiaries should pay the tax (see section 7, below).

In addition to being income tax compliant, the trust needs to have "I's" dotted and "T's" crossed, as with asset titling.

[16] This is not necessarily required, but practice in 2018 is to use a grantor's social for grantor trusts.
[17] This result is also not necessarily required, but is considered and should be considered a Best Practice.
[18] Trusts could also be grantor trusts as to a beneficiary, when the beneficiary has a withdrawal power, including an annual exclusion *crummey r*ight, under code section 678.

3. Details are painful: compliance with titling

One of the least favorite actions of any professional is completing administrative forms on titling. Different financial institutions have different requirements, the forms are tedious, and forms often get stuck somewhere in the process before completion.

Transferring title to an irrevocable or revocable trust is of critical importance. For example, with grantor retained annuity trusts ("GRATs"), the Code and regulations contemplate that title of assets will be transferred concurrently with the establishment of the GRAT.

Gifting trusts may become incomplete for gift tax purposes - a no-no -- if the intended asset is not actually transferred to the trust.

Even the straightforward funding of revocable trusts can become more sophisticated than it appears. For example, a quit claim deed transferring a residence, itself easy to complete, can invoke other needed documents. For example, consider the need to assign over the title insurance when real property is transferred into a living trust (many recent title insurance policies, like the ALTA form, do not require an assignment any more); and perhaps to notify the home insurer. If there is a mortgage on the property, ponder whether the lender needs to be notified. Under federal statutes, the transfer of property from an individual to that individual's living trust will not accelerate a loan secured by that property. However, as a matter of protocol, practitioners will often notify lenders and get that consent.

Beneficiary designations are often overlooked in the titling process, but are of equal importance. For example, we often field the question, "How can I transfer my IRA to my living trust; the IRA custodian says it has to be the owner, and no transfer is permitted?" The statement by the IRA custodian is correct, and instead of focusing on ownership at the trust level, the practitioner should consider the beneficiary designation being at the trust level (or to the surviving spouse, for rollover planning, for income tax purposes). Similarly, insurance and other beneficiary designation accounts should have the living trust as the primary (and only) designation, assuming there is no other reason to name an individual.

In terms of compliance with titling, we usually construct an excel spreadsheet with columns as to assets, suggested title, and status. On the status item, we either add to the calendar each month, or the task bar, a status question to follow up on titling until a client's full funding for the living trust is completed.

4. A taxing matter: income tax compliance

Whether we are dealing with grantor or non grantor trusts, we need to calendar tax compliance dates. These should be the following: tax filing timeline (April 15th and extensions), estimated tax payment dates (same as for individuals), determinations whether to carry out income to the beneficiaries through distributions (see below), to be done December 1 and January 30th each year, and communications in January/February to the beneficiaries about possible taxable income a beneficiary may receive for the prior year.

5. Who's calling? beneficiary communications

Not in the last 30 years has communication with beneficiaries been easier than it is today (as discussed in Section IV). We have the phone, and correspondence, but these were there 30 years ago. In addition, there is email, there is text, and there is FaceTime and other video conferencing. We have the tools to ensure proper beneficiary happiness.

Communication with beneficiaries should include the basics—that they are a beneficiary, that A and B are trustees, and that they may be receiving distributions based on [here you want to insert both the standards of the trust and the expectations of the grantor and the trustee as to when distributions will be made.]

On distributions, and what to expect annually, the best communication is a meeting between trustee and beneficiary, in person, or by phone. At the meeting, the trustee can forewarn the beneficiary as to information the trustee may need in making annual decisions, such as a beneficiary tax return.

Beneficiaries should also receive trust financial reports each year. This is critical to the trustees on two fronts. First, it avoids surprises, irritation, and beneficiary unhappiness with investments. Second, pursuant to the terms of the trust or state trust statute, it starts a statute of limitation period during which the beneficiaries have to object or be barred from thereafter questioning the trustees' actions during that reporting period.

Beneficiaries also should not be surprised about taxable income allocations. If the trustee is making a distribution that will carry out income, the trustee needs to notify the beneficiaries well in advance, even if it just an estimate.

I. Adding value with tax planning: grantor trusts

Assuming all else has been taken care of, one of the luxuries-what we can call "value added"—to engage in is tax planning. We had initially discussed the predicate determination of whether the trust is a grantor or non-grantor trust. The planning opportunities are different based on which kind of trust is involved.

If a grantor trust, we need to be focused on two categories of items, the income tax effects of the trust on the grantor, and eliminating inherent capital gain with the beneficiaries.

On the income tax effects to the grantor, we need to advise the grantor that items of income, or deduction, will flow through to the grantor and be included in the grantor's income tax return for compliance purposes. The grantor's accountant should be notified (and should, along with the grantor's 1040, file an information return, 1041, for the trust, so that all items can be more easily coordinated and demonstrated to be so).

Also, assets in the trust should be considered when focusing on the grantor's income tax planning. For example, early recognition of losses, what has become known as the "harvesting of capital losses," should be considered even at the trust level, so that the grantor can use those losses on the grantor's return.

The effect of incurring capital gain at the grantor level should be considered before any asset is sold by the trust. However, this negative effect to the grantor may be overridden by a positive effect to the trust beneficiaries.

That positive effect gets into the second category of planning item, eliminating inherent capital gain to the trust. One of the detriments of a grantor trust is that often low basis assets will find themselves as capital for the trust. For example, in a 'sale to a grantor trust' strategy, because the sale is not recognized for taxable income purposes, often low basis assets will be used as the asset sold to the grantor trust.

And these low basis assets will retain their basis at the trust level. The value of what the beneficiaries will have then becomes gross fair market value less inherent capital gains tax, which is less than gross fair market value less no tax.

The tax can be eliminated by having the trust sell as low basis capital gain asset, thereby returning the face (and new high basis) value to the trust, and jamming the grantor with the capital gain.

Alternatively, assets can be substituted into the trust by the grantor, either pursuant to an express substitution power, or a non taxable sale and purchase between the grantor and the trust.

For example, assuming the grantor trust has Berkshire Hathaway stock worth $1,000,000 with a basis of $10,000. The grantor could exchange—and this would be a non taxable exchange—the stock for $1,000,000 of bonds. The trust would then have $1,000,000 of essentially high basis assets—bonds—and the grantor would have the low basis Berkshire Hathaway stock. That low basis stock could receive a step up in basis at the grantor's passing.

The income tax basis planning for a grantor trust becomes an important add-on strategy to the overall administration

Similarly, income tax planning is important for non grantor trusts too.

II. <u>Income tax planning and non grantor trusts</u>

Here the basis issue is much more difficult to resolve. Investing at the trust level becomes more critical for non-grantor trusts in the sense that the trust's after tax return can be much different than its before income tax return.

Income tax planning by the trustee and practitioner is valuable each year.

For the trust, the planning is focused on whether the trust, or its beneficiaries, should receive taxable income in a given year. Subchapter J of the Code, the income tax provisions applying to trusts, essentially allocates income earned by a trust as between the trust or the beneficiaries, based on what has been distributed, or not, each year.

And the trustees have sixty five days after the first of each year, to decide whether to make a distribution and elect to have that distribution apply to the prior year.

For tax planning purposes, the trustee will want to make a distribution to carry out taxable income if that distribution will shift income in a meaningful way to the beneficiaries who are in a lower income tax bracket.

Ordinary income generated in a year can be shifted to the beneficiaries in that year if there is a distribution equal to or greater than that income.

Capital gain is a bit more difficult to shift to beneficiaries, but under Code section 643, the trustee can arguably shift capital gains to the beneficiaries as well. Since capital gain rates are generally the same between beneficiaries and trusts, this shifting will occur under unusual circumstances; for example, a beneficiary may have unused capital losses or capital loss carryovers; or estimated taxes have not been taken care of by the trust, but have been by the beneficiaries.

Other planning at the trust level is similar to what is done for individuals, including harvesting tax losses, moving deductible losses into different years (primarily the payment of trust and attorneys' fees), arguing that fees are not subject to the 2 % floor on miscellaneous itemized deductions because they are necessarily incurred for proper trust administration, and making sure estimated tax payments are safe harbored.'

C. Domicile planning.

The shift in focus to income taxes, and the disparity in states as to inheritance taxes, has caused a diaspora in domicile among our clients. Retired clients are often willing to shift domicile to a state with no income taxes, or one with no inheritance tax. For example, more millionaires left Illinois last year as their domicile, than any other location other than Paris, it has been reported.

D. Life insurance.

For many plans, life insurance was used, or advocated for use, as a replacement for the estate tax dollars. Whether or not the math worked on this result, nevertheless, the concept was often accepted by clients. E.g., "You have an estate tax of 5 million dollars, but you can purchase an insurance policy with a face value for 5 million dollars to replace that tax." With the increase in the exemption amount to what is currently about 11 million dollars for a married couple, a substantial majority of these prior plans/insurance policies are no longer needed.

Interestingly, for just about every client, there is a reason to consider insurance in the plan. For example, the high net worth, 100 % liquid client with 20 million dollars, may still legitimately consider insurance as an alternative investment, in his or her portfolio, to provide a guaranteed internal rate of return tied to the death benefit.

E. Basis planning.

Income tax rates keep going up, new excise type taxes are introduced (for example, the Obamacare tax), state income tax rates are going up, and the federal estate tax rate is going down. The value of federal estate tax planning is decreasing, while the value of obtaining an income tax step up is increasing. For example, for a surviving spouse with say $12.2 million dollars, that last one million dollars is subject to federal estate tax at 40 %. But that same million dollars could obtain a basis step up of 30 % (20 % cap gains, plus 3 % Obamacare, plus 7 % state tax), thereby yielding a differential of only 10 %.

The critical part of this equation is that when there is no federal estate tax, the planning must focus on obtaining a step up in basis. Therefore, a federal exemption trust set up at the first spouse's passing, that is in fact unneeded, will prevent a second basis step up at the surviving spouse's passing.

With portability, this has to be examined in more detail, and the possibility of a second basis step up planned for and, if possible, preserved.

F. Unwinding of family limited partnerships.

And the discussion in E. above becomes especially critical for older family limited partnerships. A discount of 30 % in family limited partnership assets for federal estate tax purposes will reduce the estate tax by 30 %. It will also result in either a reduction of basis (for bonds, for example, which usually have a basis equal to fair market value) for income tax purposes of 30 %, or a loss in basis step up (for appreciated assets with a low basis at death) of 30 %. If there is no estate tax, nevertheless partnership assets are still supposed to be discounted by their illiquidity and lack of control, 30 % in this discussion (could be more, could be less, depending on fact patterns). Hence, basis step up could be lost, or basis step down occurring, for no reason. Therefore, practitioners must review and unwind partnerships if the non estate tax reasons are no longer there, and if there is no estate tax reason to continue them.

G. Charitable planning (specifically, charitable lead trusts).

With the increase in the exemption, many clients feel that their children have enough assets just based on the tax free amount. Clients may want to adopt estate plans that leave amounts in excess of the estate tax free amount to charities, via charitable foundations, donor advised funds, or other strategies. Though this should have been the same result as before, the quantification of the exemption at greater than $11 million dollars has now focused clients on that amount, and how it feels to pass that amount to their children. Clients tend to be more focused on charitable planning these days. As part of the charitable planning, a charitable lead trust, the charitable cousin of the grantor retained annuity trust (GRAT), is a strategy that should take on more relevance (especially with the applicable federal rate being so low these days).

H. **Takeaway #8:** Not Risky Business.

Rhetorical question: go back to charts #1 and #2: where in the charts is trustee administration by a trusted, knowledgeable, out of the box thinking, confidante (the "practitioner") , in terms of perceived value added and risk to the practitioner?

XI. Discounts and Chapter 14: The Proposed Regulations and the Trouble That Is

Transferring minority and nonmarketable interests at less than pro rata sales or liquidation value. The proposed regulations issued on August 2, 2016 appear to be in permanent limbo.

Takeaway #9: Do Not Miss the Valuation Forest because of Stunted Discount Trees.

Planning with discounts for operating and commercial enterprises is still viable and important no matter what happens with the proposed regulations, but factor in income tax planning regarding step up in basis at death (or loss thereof).

A. Why Partnership Discount Planning with Marketable Assets is on the Wane

1. Income Tax vs. Estate Tax Planning

In 2018 and going forward, income tax planning in estate planning will be parallel in importance to estate tax planning. For estate planners, planning for the step-up in basis (until that too is repealed) is a critical step, and especially so in the partnership context. Typically, discounts for estate tax purposes reduce the potential step-up in basis and are therefore costly from an income tax perspective. That increased income tax burden will become apparent when a partner exits from the partnership.

Exiting a family limited partnership ("FLP") can occur during a client's life or at the partner's death. The exit strategy most often utilized is complete liquidation of the FLP and distribution of its assets. This is especially true with an FLP that holds primarily marketable assets, referred to as a marketable asset partnership ("MAP").

Prior to 2013, a primary focus in discussing FLPs as a strategy to clients—in addition to achieving important business purposes—creditor protection, family control of assets, consolidation of investments, retention of certain assets, diversification of others, other investment reasons, spousal protection—was on achieving valuation discounts for minimizing the client's federal estate tax ("estate tax").

Often unsaid, or at least not well explained or emphasized, to clients was and is the fact that any achieved estate tax savings would be later offset by higher income taxes on the ultimate beneficiaries of the FLP interests. Effective in 2013, it could also be offset by the burden of additional net investment income ("NII") taxes imposed on unearned income.[19]

In reality, FLPs have always been a form of tax rate arbitrage, whereby the client is accepting increased income (and possibly) NII taxes at a collectively lower tax rate for the client's beneficiaries in exchange for a reduction in the client's estate taxes at a higher tax rate. While the arbitrage may still prove beneficial from an overall tax standpoint, the net value may not be as substantial as anticipated. Furthermore, the income and, if applicable, NII tax hits will come as a surprise to many unsuspecting beneficiaries of such an interest.

As more FLPs reach maturity—here being the passing of our clients—practitioners must grapple with the challenging issue of the post-mortem liquidation of MAPs, the time at which the undesirable income and NII tax consequences of discounted MAP interests may surface. This issue's column focuses on the effect of the estate tax discount attributable to a MAP interest on the beneficiaries' income tax basis in the assets distributed to them upon the entity's liquidation and dissolution. In doing so, we explain how this effect, while not eliminating the rate arbitrage benefit of a FLP, may reduce it significantly.

2. Discount Now, Pay Later

While the discounted value of a MAP interest produces estate tax savings of 40 percent[20] for each dollar of discount, such discounted value impacts the income tax basis to the beneficiaries of the MAP interest they receive on the client's death.

At death, beneficiaries normally take a basis equal to the fair market value ("FMV") of the assets received,[21] referred to as "step-up basis," not the decedent's basis. If the FMV of a MAP interest is discounted for estate tax purposes, the basis in the MAP interest received by the beneficiaries will be equal to that discounted value.[22] By definition, that discounted value will be less than the FMV of the underlying assets held by the MAP. That difference causes the beneficiaries to recognize gain for income tax purposes upon the post-mortem liquidation

[19] The additional 3.8-percent NII tax is imposed on the unearned income of individuals, estates and trusts. Code Sec. 1411. For individuals, the tax is 3.8 percent of the lesser of (1) NII or (2) the excess of modified adjusted gross income ("AGI") over $250,000 for married taxpayers filing jointly ($125,000 if married filing separately) and $200,000 for all other taxpayers. Code Sec. 1411(a)(1). For estates and trusts, the tax is 3.8 percent of the lesser of (1) undistributed NII or (2) the excess of AGI over the dollar amount at which the highest estate and trust income tax bracket begins. *Id.* Generally, NII includes interest, dividends, annuities, royalties, rents, income from a Code Sec. 469 passive activity and net gains from the sale of investment property less expenses deductible in generating such income. Code Sec. 1411(d).

[20] Although the unified transfer tax rates contained in Code Sec. 2001(c)(2)(B) reflect progressive rates ranging from a low of 18 percent to a high of 40 percent, because of the applicable exclusion amount none of the lower rates can apply, effectively resulting in a flat-rate structure of 40 percent.

[21] Code Secs. 1014(a) and 1022

[22] *Carroll Janis*, 2007-1 USTC ¶50,210, 469 F3d 256; *Conrad Janis*, 2006-2 USTC ¶50,512, 461 F3d 1080. For an analysis of these cases and a discussion of the matching of asset values for income and estate tax purposes, *see* Gary D. Rider and Darlene Pulliam, *Matching Asset Value for Income and Estate Tax*, J. ACCOUNTANCY, Sept. 2007.

of the MAP. Such gain may also generate NII taxes. The income and NII taxes resulting from the gain offsets some, perhaps much, of the estate tax savings.

Example: Assume that a client, Mom, holds marketable assets in her own name with a FMV of $1 million and an income tax basis of $100,000 at the time of her death. The equal beneficiaries of her assets, her two children, would take a collective step-up basis for income tax purposes equal to $1 million. If the children were then to immediately sell the assets for $1 million, they would experience no realized gain or loss on the sale and, thus, they would experience no income or NII tax consequences.

What if, instead, Mom transferred the marketable assets to a MAP? Now, the underlying value of the assets in a MAP would be $1 million and Mom's income tax basis in the MAP interest ("outside basis") would be $100,000. However, suppose that a 35-percent discount is appropriate in valuing her MAP interest for estate tax purposes. The MAP interest included in her gross estate would be valued at only $650,000 [$1 million – $350,000 valuation discount ($1 million x .35)]. At a 40-percent estate tax rate, this would produce estate tax savings of $140,000 ($350,000 x .40). So far, this all looks good. Eventually, however, will come some bad, the only uncertainty is how much.

Upon Mom's passing, the two children decide to liquidate and dissolve the MAP.[23] The estate tax valuation of $650,000 becomes the children's collective outside basis in the MAP interest for income tax purposes. When the MAP makes a *pro-rata* distribution of its assets, worth $1 million collectively, to the children, they will experience a collective realized gain of $350,000, but none of this may be recognized due to a special rule underlying liquidating distributions from investment partnerships (discussed *infra*). The children will take a basis in the assets distributed in the MAP equal to the outside basis of the children's interests in the MAP, collectively $650,000, reduced by any actual money distributed to them in the same transaction, here assumed to be zero, or $650,000.

If the children were to then sell all of the distributed assets for FMV, they would generate a collective realized and recognized gain of $350,000 ($1 million amount realized - $650,000 adjusted basis). The gain would be capital in nature since the assets were held for investment.[24] As inherited assets, the holding period of the capital assets would be deemed to be long-term,[25] resulting in long-term capital gain ("LTCG"). LTCG is subject to a maximum preferential tax rate, which varies depending on the taxpayer's normal marginal income tax rate. A zero-percent rate applies to taxpayers with a normal marginal rate of either 10 or 15 percent; 20 percent applies to taxpayers with a normal rate of 39.6 percent; and 15 percent applies to taxpayers with normal rates between 15 percent and 39.6 percent.[26]

Suppose that children both had a normal marginal rate of 39.6 percent such that the preferential rate on the $350,000 of LTCG generated by the liquidating distribution is 20 percent. This means that the children would collectively pay $70,000 ($350,000 x .20) of additional income taxes as a result of the estate tax discount. But, the story does not end there. Since LTCG are a form of unearned income, the $350,000 potentially would be subject to an NII tax of 3.8 percent or $13,300 ($350,000 x .038). Further, if the beneficiaries are subject to

[23] A number of factors may trigger this decision. One such factor, for example, may be that the two children develop irreconcilable differences regarding the investment strategy for the MAP.
[24] *See* Code Sec. 1221(a).
[25] Code Sec. 1223(11).
[26] Code Sec. 1(h)(1). In addition, there are two other LTCG maximum preferential rates that may apply in certain circumstances. A 28-percent rate applies to "collectibles gain." Code Sec. 1(h)(4). A 25-percent rate applies to "unrecaptured section 1250 gain." Code Sec. 1(h)(1)(D).

state income taxes, the LTCG would be subject to state income taxes. So, for example, suppose that both of the children resided in a state with no estate tax (thus, the $350,000 estate tax discount would have produced no state estate tax savings) but has a flat income tax rate of five percent. The LTCG would result in additional state income taxes of $17,500.[27] The grand total of additional income and NII taxes on the children would be $100,800 ($70,000 + $13,300 + $17,500). While the estate tax savings of $140,000 due to the discounted MAP interest seem impressive when viewed in isolation, they seem much less so once the eventual impact of the income and NII taxes on the children is considered.

Practitioners may be willing to accept these results—avoid tax now for some tax burden later. After full disclosure and explanation, clients may be fine, too, with the strategy. But disclosure is critical to avoid surprises and questions (from the client's family members) down the road.

The partial step-up in basis for the beneficiaries (from the client's outside basis in the MAP of $100,000 to the discounted value of $650,000 at date of death), coupled with the $350,000 estate tax discount resulting from the FLP strategy, produces a net overall tax savings of $39,200 ($140,000 of reduced estate taxes – $100,800 of increased income and NII taxes). It may not be a win-win, but the estate tax victory still overcomes the income and NII losses. In those cases where there is a step-down in basis—partnership funded with bonds, for example—the practical results of moving forward may not be as attractive.[28]

3. Does the Analysis Change if the Assets are not Appreciated in Value?

In the prior Example, the MAP's underlying assets had a low basis relative to FMV. On surface, one might conclude that this is what caused the backside negative income and NII tax consequences to the beneficiaries. But, this is not necessarily true.

In recent years, the potential for encountering portfolios with assets that have depreciated in value, such that basis exceeds FMV, or in which there is no appreciation, such that basis equals FMV, has been great. Intuitively, one might conjecture that such portfolios would not produce any of backside negative income and NII tax consequences the beneficiaries experienced in Example. Unfortunately, that is not true. Here's why.

4. Can I Please Have My Partnership Assets Now that Mom Has Died?

While succinct, the analysis in the prior Example does not provide an adequate basis for fully understanding the resulting income tax consequences associated with the post-mortem liquidation of a MAP. The following discussion sheds a bit more light on the area.

Code Sec. 731 provides the general rules governing the recognition of gain or loss on a distribution of partnership assets in a liquidating distribution. Under Code Sec. 731(b), the partnership recognizes no gain or loss on such distributions. Under Code Sec. 731(a), the partner recognizes no gain on the distribution except to the extent that cash distributed

[27] The state income taxes are deductible as an itemized deduction. If each child itemizes, the payment of the taxes would generate federal income tax savings on their individual federal income tax returns to the extent that the taxes are not subject to the phase-out of itemized deductions (also known as the "cutback adjustment") under Code Sec. 68 and, then, only to the extent that the total itemized deductions after phase-out exceed the child's standard deduction. For simplicity, the computation in arriving at the collective federal income tax of $70,000 ignores the possibility of such savings.
[28] Further, all current partnerships should be reviewed to determine if the discount is still necessary in light of the increased estate tax exclusion amount to $11.180 million.

exceeds the partner's outside basis immediately before such distribution.[29] Loss is recognized by the partner only on the receipt of money, unrealized receivables and inventory.[30] For both gain and loss purposes, "cash" may include marketable assets.[31]

In operating partnerships with real estate or other business operations, the partners typically experience no gain on liquidation and distribution of assets because there is often little cash to distribute in such partnerships. Thus, the cash distributed to each of the partners typically does not exceed his or her outside basis in the partnership.

With a MAP, the analysis gets more complicated. Since a MAP's assets are typically comprised of cash and/or marketable assets, all of the assets distributed may be deemed "cash." At first blush, a practitioner may conclude that because a beneficiary receives a partial step-up (to the discounted value used for estate tax purposes), the amount of cash to be distributed will not exceed its outside basis. But, this is not true due to the discount taken for estate tax purposes.

In Example, there is a disparity of $350,000 between the FMV of the underlying MAP assets and the children's collective outside basis in the MAP interests, the discounted value of the MAP interests in the Mom's estate. In that example, the value of the deemed cash distributed, $1 million, will be greater than the children's collective outside basis, $650,000.

Without an exception to the gain recognition rule in Code Sec. 731(a), the liquidation and asset distribution would result in $350,000 of collective recognized gain to the children. Code Sec. 731(a)(3)(A)(iii), however, provides such an exception. Under that provision, the children would recognize no gain so long as the distribution was made by an (1) "investment partnership" to an (2) "eligible partner."[32] A partnership qualifies as an "investment partnership" if it has never been engaged in a trade or business and if substantially all[33] of the entity's assets, by value, have always consisted of cash or investment-type assets listed in Code Sec. 731(c)(3)(C)(i)(II)–(VIII).[34] This includes corporate stock; notes; bonds; debentures or other evidences of indebtedness; interest rate, currency or equity notional principal contracts; foreign currencies; certain interests in or derivative financial instruments; other assets specified in regulations; and any combination of any such assets.[35]

An "eligible partner" is a partner who, before the date of distribution, had never contributed any noninvestment type assets to the partnership.[36]

Typically, a MAP should qualify for this exception. Usually, a MAP will be an "investment partnership" because it is not engaged in a trade or business, and almost all—if not all—of the MAP's assets consist of money, stocks and other publicly traded securities. The distributee partners, the beneficiaries of the MAP interests, generally will not have made any contribution

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[29] Code Sec. 731(a)(1).
[30] Code Sec. 731(a)(2).
[31] Code Sec. 731(c). However, the determination of whether the distribution of marketable assets will be treated as a cash distribution is complicated because, among other things, several exceptions apply. For a discussion of these complications, *see* HOFFMAN, RAABE, SMITH, MALONEY & YOUNG, CORPORATIONS, PARTNERSHIPS, ESTATES & TRUSTS: 2014 EDITION (South-Western Cengage Learning), at 11-12 and 11-13. For purposes of this article, we are assuming that none of the exceptions apply.
[32] Code Sec. 731(a)(3)(A)(iii).
[33] "Substantially all" is defined to mean 90 percent or more. *See* Reg. §1.731-2(c)(3).
[34] Code Sec. 731(a)(3)(C)(i)(I)–(VII).
[35] Code Sec. 731(a)(3)(C)(i)(II)–(VII).
[36] Code Sec. 731(c)(3)(C)(iii).

of assets to the MAP or, if so, such contributions would have been cash or investment-type assets. This makes each of them an "eligible partner." As such, liquidation distributions of MAP assets generally should result in no gain recognition to the distributee partners.[37]

5. But Wait, There Are More Possibilities for Gain

Even if the investment partnership exception applies, there are two other provisions that seemingly could cause the distributee partners to recognize gain on the liquidation of a partnership: Code Secs. 704(c)(1)(B) and 737.[38] Under Code Section 704(c)(1)(b), if a partner contributes appreciated property (*i.e.*, FMV exceeds basis, such that there is "built-in gain") to a partnership and such property is distributed to another partner within seven years of such contribution, the contributing partner must recognize gain or loss as if the property was sold at its FMV on the date of distribution.[39]

Thus, in Example, if the liquidation of the MAP occurred within seven years of Mom's contribution of the marketable assets to the MAP, it would appear that the children may have to recognize gain. Fortunately, that is not the case. Regulations provide that a transferee partner, here both of the children, "steps into the shoes" of the transferor partner, here the Mom, for Code Sec. 704(c) purposes.[40] Thus, even if Mom had contributed the appreciated marketable assets to the MAP and the entity distributes such assets to the children (as beneficiaries of Mom's MAP interests) within a seven-year period, no gain would be recognized. The distributions are not being made to "another partner" since the children step into Mom's shoes. Since Mom and the children are treated as one and the same partner, there should be no triggering of the built-in gain (assuming a *pro rata* distribution of each security).

Code Sec. 737 supplements Code Sec. 704(c)(1)(B). It applies if a partner contributes appreciated property to a partnership and then within seven years of such contribution, receives a distribution of other appreciated property.[41] Thus, like with Code Sec. 704(c)(1)(b), it would seem that the children in Example might have to recognize gain on the liquidating distribution. Fortunately, again, that is not the case. The Code Sec. 737 regulations incorporate by reference Code Sec. 704 regulations' "steps in the shoes" rule.[42] As such, Mom and the children would again be viewed as one-and-the-same partners. As such, no gain is triggered.[43]

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[37] Even if Code Sec. 731(c) did apply, the amount of recognized gain is limited pursuant to Code Sec. 731(c)(3)(B). For a discussion of this issue, *see* Bryan E. Keenan, *Partnership Terminations: Breaking Up is Hard to Do*, 2003 Delaware Tax Institute (Revised February 2004), at 4-5.
[38] Gain on a liquidating distribution could also arise under Code Sec. 752(b). Under that provision, a constructive distribution of cash arises if a partner is relieved of some of all of his or her share of partnership liabilities. In a typical MAP, there would be little or no liabilities. As such, this provision would not normally serve to trigger gain recognition in the liquidation of a MAP.
[39] The gain or loss would be limited to the amount that would have been specially allocated to the partner. Code Sec. 704(c)(1)(A).
[40] *See* Reg. §1.704-4(d)(2).
[41] The recognized gain is limited to the lesser of (1) the distributee partner's remaining unrecognized pre-contribution gain or (2) the excess of the property's FMV over such partner's outside basis in the partnership. Code Sec. 737(a). The outside basis first must be adjusted for cash or deemed cash distributed. *See* Reg. §1.737-1(b)(3)(i).
[42] Reg. § 1.737-1(c)(1).
[43] The discussion to this point has purposely assumed that the partnership has made no optional basis adjustment election pursuant to Code Sec. 754. As one commentator notes, if such an election were in effect, "then the step up in the basis of partnership assets will tend to eliminate the precontribution gain that is the precondition to the application of §§704(c) and 737." Mark P. Gergen, *Potential Trap in Liquidating a Family Limited Partnership*, 29th Annual Advanced Estate Planning and Probate Course (June 8–10, 2005), at 1.

Phew, No Gain on Liquidation, but What Happens When I Sell Those Assets?

Even on the assumption that there is no gain on the liquidation and dissolution of the MAP, the story does not end. Surprised? Most practitioners probably are.

Pursuant to Code Sec.732(b), the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is equal to the adjusted basis of such partner's interest in the partnership, reduced by any actual money distributed in the same transaction. The effect is that the basis of the distributed assets to the beneficiaries in the liquidation of a MAP will be reduced to the discounted value used for estate tax purposes.

Example: Assume that Mom transferred marketable assets to a MAP. At the time of Mom's death, the FMV of the underlying MAP assets and Mom's outside basis in the MAP interest are both equal to $1 million. That is, there is neither appreciation nor depreciation in value. If a 35-percent estate tax valuation discount is achieved, Mom's MAP interest will be included in her gross estate at a value of only $650,000, and the children will take a collective outside basis in their MAP interests of $650,000 (as in Example). On liquidation, if the special rule for nonrecognition related to investment partnerships applies, the children will report no gain as a result of the distribution of the MAP assets even though the deemed cash distributed, $1 million, exceeds the children's collective outside basis, $650,000. They will take a collective basis in such assets equal to their collective outside basis immediately before the distribution, $650,000, less any actual cash distributed to them, here assumed to be zero, or $650,000. So, even though the assets in the MAP had no built-in gain (*i.e.*, basis and FMV were both $1 million) because of the estate tax discount the children will take a basis in such assets of $650,000, resulting in a built-in gain of $350,000 ($1 million FMV – $650,000 basis). As in Example, once the children sell such assets, this gain will result in LTCG subject to income taxes and NII taxes. Undoubtedly, this will come as quite the shock to the children, as it would to the vast majority of beneficiaries of any MAP.

The problem is exacerbated by the fact that brokerage houses do not (nor would they reasonably be expected to) focus on basis adjustments in marketable assets needed as a result of the distribution of an FLP's assets. As a result, clients will be unprepared for the income and possible NII tax hit that they will face when they sell the distributed assets.

Example: Assume that the assets held by the MAP in Example consist entirely of corporate bonds, in which the MAP has a basis of $1 million. At Mom's death, the FMV of the bonds is $1 million but, due to an estate tax valuation discount, the MAP interests are valued for estate tax purposes at only $650,000. When the MAP is liquidated and dissolved, the bonds are distributed to the children. They, in turn, establish new brokerage accounts to hold the bonds. The bonds should have a collective basis on the new brokerage accounts of $650,000. Unfortunately, the new brokerage accounts will often-times carry over the MAP's basis of $1 million. The result is that the children (and perhaps their income tax preparers) will likely be unaware of the fact that if the bonds are sold for $1 million, $350,000 of gain will need to be recognized.

Someone should be advising the brokerage house of the new basis. Who should that be? In all likelihood, the children will be oblivious to the issue. The children's income tax preparer, especially if not well-versed in partnership taxation, may be equally oblivious. The preparer will likely rely on the brokerage house for the basis information, which will be erroneous in most cases. This could really be problematic because, on audit, the failure to report the gain will not only result in the assessment of applicable income and NII taxes but also in potentially large amounts of interest charges and penalties. That leaves only one person standing: the practitioner. He or she is the one who advanced the FLP strategy to the client and who would likely be the only one sensitive to and knowledgeable about this issue.

6. Can I have my Cake and Eat It Too?

For husband and wife planning, the concept of "having your cake and eating it too, without the cake being gone," could be planned for. If a partnership is set up, for all the valid reasons that partnerships are set up, then certain actions could be taken at the first spouse's passing.

Assuming discounts are allowed, the partnerships can be strategically allocated at the first spouse's passing. For example, in a typical limited partnership, the general partnership interests represent five percent of the equity, and the limited partnership interests represent 95 percent of the equity. Strategic allocation of both pieces of the credit shelter trust has immediate estate tax advantages and future income tax advantages.

Example: In 2014, Husband passes away owning half of the general partnership interests (2.5 percent) and half of the limited partnership interests (47.5 percent) in a partnership with a face value of $10 million. At a 40-percent discount, the limited partnership interests are worth $2.85 million [$6 million ($10 million - $4 million valuation discount) x .475] and the general partnership interests, at no discount, are worth $250,000 ($10 million x .025). Assume both interests are contributed to the credit shelter trust (now to be funded with $5.34 million of assets in 2014). This allows more funding to the credit shelter trust, as it will have another $2.24 million ($5.34 million - $3.1 million) to fill its coffers.

Now assume that the limited partnership converts to a general partnership as easier to manage and to achieve the same investment objectives. If the credit shelter trust is treated as a grantor trust under Code Sec. 678, the surviving spouse can buy (for cash or high basis assets) the partnership interests from the credit shelter trust, this time at no discount because the limited partnership interests are gone. The purchase price is $5 million, into the credit shelter trust. The credit shelter trust will now have $7.24 million with full basis. Initially, the basis in the hands of the surviving spouse of the general partnership interest is $3.1 million, a carryover basis ($2.85 million + $250,000). At the surviving spouse's passing, however, that basis will get a step up to FMV, or in this example, $5 million. A caveat to this example: the variables can evolve based on the law, and the Code Sec. 678 treatment could be viewed as aggressive.

7. Communication is Key

When estate tax rates were relatively high and income tax rates were relatively low, ignoring or under-emphasizing the tax rate arbitrage aspects of a FLP was perhaps defensible. However, in the current environment—with increases in income tax rates and the creation of the additional 3.8-percent NII tax on unearned income—it no longer is.

The initial planning discussion with a client considering an FLP strategy, even with discounts waning because of the proposed regulations, including a MAP, should highlight the important fact that eventually there will be income taxes and NII taxes that may result when the assets are sold, anticipated to occur after the MAP is liquidated and dissolved. Reminding the client's beneficiaries of this fact during the liquidation and dissolution process will be prudent and protective to the practitioner. Additionally, advising the beneficiaries of the required basis adjustments resulting from the estate tax discount will serve to ensure that the recognized gain is properly and timely reported by them, so as to avoid any unnecessary interest charges and penalties.

A final item must now be considered for older partnerships: Are they still needed for estate tax protection? With the applicable exclusion amount increased to $11.180 million in 2018, if a discount partnership is not needed, consider liquidating it or otherwise creating a mechanism so that the discount at passing—and basis step down or reduction—does not occur.

Takeaway #11: "Stupid Is as Stupid Does."

We have to be cognizant to income tax planning when it comes to discounted family partnerships, especially those funded with marketable securities. Long before the proposed 2704 regulations, the marketable asset partnership for estate tax purposes became a strategy of excessive effort/limited value. The possible tax savings would be marginal estate tax rate(40 %) -loss of basis step up * rate (cumulative, about 30%) * Potential discount (35 %), or 3.5 % of the value of the decedent's interest in the partnership. Only if the basis was not lost (via a lifetime transfer), could the strategy make sense.

C. But Valuation Planning Still Makes Sense

1. Closely Held Businesses.

Regardless of the specificity of Code rules as to the valuation of most assets, there is one asset type whose valuation methodology is still left uncertain: the closely-held business interest, defined to be an interest that is not traded on a public market. Closely held corporations are typically thought of as family businesses, but in reality, encompass a wider range of businesses and include all those business interests that are not publicly traded. The closely held business that has garnered the most attention of recent in the estate planning world is the so-called family limited partnership.

2. Revenue Ruling 59-60.

Attempts are given in the Code to prescribe variables and boundaries to value these closely-held business interests, but not much certainty is provided. For example, the operative revenue ruling, Rev. Rul. 59-60, 1959-1 C.B. 237, sets forth various factors to be considered in any valuation:

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

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

c) The book value of the stock.

d) The earning capacity of the company.

e) The dividend-paying capacity of the company.

f) Goodwill and other intangible value.

g) The size of the block of stock to be valued.

h) Market price of comparable traded companies.

3. Rubber Hits the Road.

The ruling then goes on for 8 pages to explain considerations for each of these factors. The reality, however, is that even after 55 years of existence, the Revenue Ruling has not been a guiding light in determining the value of closely held businesses. Rarely has a Ruling had less impact, or more frequent citing, than Revenue Ruling 59-60. The reality is that despite the Jello-like guidance provided by this Ruling, significant advancements in valuation techniques over the last twenty years have provided substantial guidance and insights into proper methodology to value closely held business interests.

4. <u>Importance to the Planner.</u>

Incorrect valuations have tremendous effects, typically deleterious, to estate planning transactions. Inaccurate valuations can result in the ineffectiveness of various estate planning strategies, as well as the actual payment of gift taxes. Widely incorrect valuations could result in a wide array of potential penalties, ranging from underreporting, to valuation understatements. And the mere shrug of the estate planner's shoulder with the retort, "well, we relied on the business appraiser we hired," is a bit dangerous in this litigious environment. Instead, the attorney has to independently evaluate the propriety of a business appraisal, and understand the likelihood of success of the appraisal; and more importantly, the tension points in the valuation that could be the subject of IRS review.

Example: Assume that a sale is made to a family member of a 50% interest in a closely held corporation valued at $3,000,000. The 50% interest is discounted by 33% to $1,000,000. No gift tax return is filed because the sale is for what the buyer and seller believe to be adequate and full consideration, thereby falling within the exception under Treas. Reg. § 25.2512-8. If, however, the Service on audit determines that no discount should have attached to the interest, or that the starting value of $3,000,000 for the corporation was incorrect (assume it was really $5,000,000), then there could be a taxable gift (depending on the seller's remaining unified credit). And the non filing of the gift tax return would result in an underreporting penalty under § 6651(a)(1) of 5% per month.

5. <u>Definition of "Value".</u>

The real value of the closely-held interest is what it would sell for to a third party on the relevant valuation date. Treas. Reg. 26 C.F.R. § 20.2031-1(b) and 26 C.F.R. § 25.2512-3. This is usually measured by what a similar interest in the same company has sold for to a third party on that date. But because the interest is not publicly-traded (a result that emanates from the definition of a closely-held interest), there is generally no comparable interest in the same company that has sold on that date.

Accordingly, in a conceptual sense, the taxpayer has to approximate what the interest would sell for to a third party on that date. And the reality is that there is typically a range of values as to what the interest might sell for. The taxpayer and the Internal Revenue Service (the "Service") have disparate objectives as to which point on the range they would desire.

Example: A closely held corporation is engaged in the business of distributing screws and bolts. On average, it buys screw, bolts and related hardware from China at 50¢, and sells them to end-users, Walmart and Home Depot, for $2 per item. Its gross profit is $1.50, and after all fixed and marginal expenses are taken into account, its net profit is 30¢ per item. On average, it sells 10,000,000 bolts per year, and has a net profit of $3,000,000 ($3M) per year. Dad has used his full estate and gift tax credit as to gifts during life.

The 100% owner of the business dies on January 1, 2004, and he has no surviving spouse. Consider the value of the business in this over-simplified example. (Many additional variables will need to take into account, including a cash flow that is not going to be even, that there are different expenses, competition pressures, different margins, growth rates, and a host of other variables that will impact cash flow from year to year.)

Because there is estate tax, the father's estate would like a low value and the IRS would like a higher value.

If these cash flows were valued as if they would be achieved in perpetuity, then the value of the company that a hypothetical willing buyer would pay to this hypothetical willing seller, each being under no compulsion to buy or sell, would be the $3M cash flow divided by an interest rate attributable to the risk of these cash flows relevant to a risk-free interest rate over the same time period. Assume the relevant risk-free rate is 5%. At an 8% risk-adjusted rate, the value is ($3M/.08) = $37.5M. At a 10% risk adjusted rate, the value is ($3M/.10) = $30M. There is no definitive guideline as to what the risk adjusted interest rate should be. Accordingly, the possibility for controversy between the IRS and the taxpayer is clear. In this example, reducing the controversy to merely the risk factor to be used in valuing the cash flows to perpetuity, there is a $6 million divergence in value, resulting in an approximate $2.4 million in federal estate tax at controversy.

6. <u>The Actor on the Valuation Stage: Your Role.</u>

Ponder the attorney's role in the review of a valuation. Part of that universe is known: review the level and discussion of discounts for minority and lack of marketability. This area is the topic of 95% of discussions we have as estate planners.

The next part is more amorphous: how does the overall valuation looks in terms of avoiding an audit, and defending at the audit level, the appellate level, or the court level. What are we doing to add value in terms of changing the valuation.

And how are we bolstering the valuation to prepare for a defensive and believable audit. We need, and herein provide, the heuristics, for the practitioner to conduct a review of the business or other valuation report. We can rely on experts, valuation professionals, to do the heavy lifting.

7. <u>Oh Gee, Here is the Report. Great.</u>

Heuristic: Develop a Game plan.

Prior to engaging the appraiser, take a walk through the financials, and a discussion with the client, and assess the likely method of valuation and approximate value

You may want to let the client know your role here, and the time that you will be spending. How much time will you put in, can you put in—3 to 5 hours?

Heuristic: Beware False Leads.

Forget the terminology and start at the basics as to what really matters. And think logically—if someone offers you an investment that you do not understand, are you going to do it. As attorneys, we need to take the same approach to valuation—if we do not understand what the appraiser is doing it is probably because the appraisal is either garbage or fraught with inconsistencies.

Is the valuation logical and easy to follow? If I do not understand it, what is it that the valuation professional can do to make me understand it.

Example: If something doesn't make sense, why is it in there? Does it need to be there? Yes or No:

a. Operating business valued on an EBITDA basis. We go to balance sheet to do add backs and subtractions. Do we need to add back to have arrived at EBITDA number (* multiple), "good will," or capital equipment? Subtract unpaid Accounts Payables. Short term liabilities, subtract? Add back retained earnings? What does common sense tell you?

b. Marketable securities partnership: does the fact that the marketable stocks are paying 3 % in dividends factor into the valuation, directly?

c. A Tax Court case says that dividends paid are probative and methodology to be followed. Hmmm. Does this make sense? (Which goes to show that even logic sometimes gets trounced with a well-reasoned argument, since the Tax Court bought this one hook, line and sinker.)

d. I have a buy sell that allows purchase and sale at "book value." I argue this is meets the 2703 comparability test. Logical?

See Exhibit A for answers.

Heuristic: The Book does not match up with the cover.

There are primarily three approaches that will be of relevance to us: (1) market value of assets; (2) multiple of EBITDA; or (3) discounted present value of future cash flows.

Heuristic: You only need to review the Sports Section.

Status Quo Bias indicates that we will accept what we have, even if it doesn't make sense or is not what we need. Hence, think of our beneficiaries with single stock concentrations that they inherit. Hard for them to change and diversify, because it requires an actual action.

In reviewing valuation, our status quo bias is that we will usually review the report that is in front of us, without asking the question, "What is it that we should be reviewing."

Remember, it all starts with the financials.

8. Valuation Techniques of Relevance.

Heuristic: Estimate Spousal Value Prior to Marriage.

In planning for GRATs, or sales, or even straight taxable gifts to a grantor trust, you can estimate the business value before you have a formal valuation. You get the financials, or tax returns, and from those, use the techniques below to estimate value.

For example, for a holding company that is more reliant on underlying asset value—like a marketable securities partnership—a balance sheet, fair market value approach is more appropriate.

Heuristic: The Valuation Universe Has Only So Many Planets.

There are only so many valuation approaches. Of course, don't forget that if an interest in the business has been sold, that should be more probative than resort to any of the following approaches. Similarly, if there is a completely similar business (or businesses) that have been sold, those sales should be a good proxy for our company's valuation.

Really, there are three approaches of most relevance: market value on liquidation, EBIT or EBITDA, and free cash flow. They are masqueraded under various names, discussed below.

a. Liquidation Value (also known as asset approach, cost approach, underlying asset method, and adjusted book value method). Essentially, this is the value of the enterprise if it were immediately wound up and the assets or proceeds distributed. For example, assume an S corporation is holding only vacant land suitable for development. And assume that the corporation is not renting the land, and is holding only that land for investment. No cash flow or earnings are generated. The value of the S corporation at any given time is the value of the land it holds, assuming the land was sold. An approach using "earnings" or "cash flow" discussed below, would render the S corporation's value at 0; and clearly does not approximate value.

Example: A company that holds assets for investments, such as a publicly traded mutual fund, usually is valued based on the value of its underlying net assets. Family limited partnerships that hold publicly traded assets should be valued, initially before discounts, based on the underlying value of the assets, using this liquidation value approach.

Heuristic: Show me the money.

There are, heuristically speaking, two approaches to valuing operating companies that are generating income: multiple of EBITDA, and discounting future cash flows. To me, they should both be called VALUING OPERATING PROFIT.

Heuristic: Cash is king. Cash flow is queen.

For an operating company, valuing "profit" under one of two accepted approaches, multiple of EBITDA, or discounting free cash flow, regardless of the name they are masqueraded under, is the right approach. Sure, on the fringes, other methods can be trotted out there.[44] Case law in applying an EBITDA or DCF approach is "interesting." *See, e.g., Wall v. Comm'r,* T.C. Memo 2001-75, and *Deputy v. Comm'r,* T.C. Memo 2003, 176.

b) EBIT or EBITDA.

Earnings Before Interest, Taxes (EBIT), Depreciation and Amortization (EBITDA) (also known as the Market Approach).

Heuristic: Earnings are to EBITDA as Law School is to Being a Lawyer.

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[44] Rarely is book value used though businesses do sell on an open market based on a multiple of book value (e.g., financial institutions). Courts have used dividend paying capacity as a measure. Why? I don't know. The "discounted dividend method" has been cited by courts as an acceptable valuation methodology. My opinion, that's sort of bull manure. For one thing, this model only captures the cash flow that is expected to be distributed to the equity holders. No value is ascribed to the capital appreciation of the business. Start-up companies usually use an option approach, something akin to a pro forma discounted cash flow with a substantial discount rate. Accountants sometimes use a multiple of earnings approach, as does the public stock market. These include the oft-cited prices based on: multiple of revenues or earnings. Hence, publicly traded stock whose value is based on PE multiple of say 8, is a short way of saying that it trades at a price equal to 8 times its recent earnings. Price could also be determined based on other accounting items, such as a multiple based on book value. These are accounting items because they do not necessarily represent cash received by the company and are based on accrual concepts. Prices based on accounting multiples are often used as proxies for cash flow pricing in the public market, as these multiples are readily and easily obtainable.

Earnings on a tax return or a financial statement is not EBITDA. EBITDA adjusts earnings to lead to a number that is valuable to a buyer. For example, let's say I sell hot dogs in front of the University of Alabama football games. My cost for dogs is $10,000. I get revenue of $20,003 per game ($3 tip). As a buyer, I see net profit in there of $10,003, so I may be willing to pay 10 * net profit of $10,003, or $100,030. However, if I looked at the income of Mr. Hot Dog vender on the income statement, it may say only $3/year. That is because he bought a $200,000 shop to sell the dogs out of, that he is depreciating $10,000 per year on an income statement. It is only when depreciation is added back to income (EBITDA), that I get the more meaningful figure of $10,003, the starting point by which I may want to assess the value of the business.

It essentially starts with an accounting figure, earnings (E), and adds back significant accounting items, interest expense (I), taxes (T), depreciation (D), and amortization (A) to determine the available cash flow generated by the company, irrespective of capital structure. The multiple of EBIT(DA) in which publicly traded comparable companies trade also provides a starting point for a valuation based on EBITDA.[45]

c) <u>Free cash flow (also referred to as "discounted cash flow" or the Income Approach).</u>

Of course, it has nothing to do with income as we estate planners think about. It is really cash flow. This essentially determines the cash generated and to be generated from the business, and available to be distributed to shareholders, after setting aside reserves for capital expenditures and net working capital.

It is often based on pro forma projections going forward of how the company will perform, assumes a growth rate for the cash generated, and discounts future cash flows based on the cost of capital concept, roughly, what level of return investors would require for investing in this type of business.

Valuation based on cash flow analysis is reasonable if the business is actually generating cash (e.g., a partnership holding marketable assets is not really generating cash flow on an annual basis), and a review of the "reasonableness" of the cost of capital assumption should be made in the appraisal. Usually free cash flow is, in the investment world, determined after taxes are paid. However, because many of the valuations are in the S corporation context, courts have discussed whether the cash flow must be before taxes are taken into account, and then subject to the discount rate. *See, e.g., Adams v. Comm'r*, T.C. Memo 2002-80 (2002) and discussion below.

Heuristic: Focus on what is it that we should know about EBITDA and FCF approaches.

First and foremost, you don't have to know how to do it You need to know the key variables that we, as planners, can use to most influence valuation. The Multiple or Discount Rate is one focus. For EBITDA, adjustment to earnings is another factor. For free cash flow, the build-up of the cash flows offers opportunities.

But the starting point is the multiple or discount rate. For EBITDA, we use a multiple. For DCF, we use a discount rate.

9. <u>Discount Rates and Multiples.</u>

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[45] The financial statement or public companies either lists EBIT or provides sufficient financial data for EBITDA to be evaluated.

Heuristic: The discount rate and the multiple are heads and tails of the same coin, i.e., the same thing.

In the Wall Street Journal reporting of prices of stocks, there is often listed the price of the stock based on a P/E. The P/E is the Price- to- Earnings ratio, meaning that the stock selling at $20, based on a recent earnings report of $1.00 for the last fiscal year of the Corporation, would have the Corporation selling at 20 times earnings. In that regard, the multiple used against earnings to value that Corporation, as implied by its market price, is 20.

Conversely, that multiple can be expressed as a discount rate. For example, if an expectation of $1 is being priced at a multiple of 20, this could also be written as a percentage (1/20), or $1/5% (which equals $20). This means that an investor requires a 5% return on its investment in that Company's cash flow. (ASSUMING CASH FLOW TO REMAIN CONSTANT AND NO EXPECTED GROWTH IN EARNINGS.). (See Exhibit A)

Accordingly, whether the valuation is expressed as a multiple or discount rate, the same concept underlies the chosen number: what rate of return does the investor desire for the expected cash flows to compensate the investor for the risk that the investor's principal will be eroded or eliminated?

Heuristic: Pre-valuation, intuit what you think the discount rate or multiple should be.

Example**:** Given the uncertainty of distributions to me of cash flow/or call it earnings, what multiple of current earnings am I willing to pay. For example, a start-up company in its 5th year now produces $2,000,000 of net profits a year. After reserving a certain amount for capital expenditures, and other cash reserves, and to account for timing differences between recognizing income and expense, and receiving or paying cash for that revenue or expense, there is about $1,700,000 of free cash at the end of the year. The Company is now experiencing substantial competition, future cost increase, and is not expanding in a way that makes one think that revenues and profits are going up. How much will you pay for the business based on this 1.7m of cash flow? 3 to 5 times current cash flow? That equates to a discount rate of 33% to 20%.

As you look at your client's business, before the appraisal, you will have in mind what the multiple (and therefore the discount rate) will be; likely in the 3 to 12 range, or 33% to 8% in discount rate.[46]

Example: Aside: think of rental apartments that are selling at a 4 % discount rate. That is a 25 times multiple. In other words, the buyer, the market in this case, believes the rental revenue stream carries minimal risk, will continue at that rate or higher in the future. That discount rate is only slightly higher than a long term Treasury Bond (2.4%), an asset whose income is

[46]What does the Concept of Applying a Multiple Mean? A Company that is being valued based on future expected profit (free cash flows or earnings) is, in its simplest form, being priced based on an expected annual cash flow or profit (X) times a certain number of years expected for that cash flow (Y). This is often expressed in different ways. Example: When Amazon first went into business, it spent a number of years generating quite a bit of revenues, but no profitable cash flows that could be distributed to shareholders as dividends. Nevertheless, shareholders were willing to pay $10, or $15, or $20, to own that stock. A pessimist (or gambler) might say that the shareholders were willing to pay that solely because they believed other future shareholders would pay more. Alternatively, there may have been a belief by those current shareholders that Amazon would soon start producing free cash flow per share of $.5 per year, or $1.00 per year, for a number of years, and that this cash flow would be available to them in the form of dividends. In that way those shareholders, at $1.00 per share, were in essence valuing Amazon at $1.00 * 20 (the multiple to earnings), to arrive at a $20/share valuation.

as risk free as possible.[47]

Heuristic: The riskier the likelihood of cash flows, the lower the multiple, and therefore the higher the discount rate in valuing a business.

Intuitively, the multiple or discount rate refers to the risk inherent in an investment, and the type of return that an investor would want in order to justify that type of risk.

a. <u>30 Day Treasury Bill.</u>

Ponder how risky a 30 day Treasury Bill is in the market. First, the debt obligation gets paid off in 30 days, so the investor's money (his investment) is not being held outside of the investor's hands for a long period of time. Second, the promise to pay off the debt obligation is being issued by the United States Government. The United States Government has better credit than any financial institution (I hope), and certainly has one of the best, if not the best, creditworthiness of any government in the world. The current odds of the United States defaulting on a short term obligation are very remote. Because of these two factors, it would be safe to assume that the risk inherent in this investment, in terms of an investor getting back her initial investment at the end of 30 days, is close to zero. One could argue that it approximates a "risk-free" investment. Therefore, the expected return that the investor would want from the United States government for this debt obligation could be very small. And it is. Current 30 day Treasury Bill rates are way less than ½% to 1%.

As investments get more removed from short-term government debt, the risk of the investment (in terms of getting the principal back at some time in the future) increases, and the rate of return that the investor desires increases. Risks associated with an investment can be tied to longevity, illiquidity, enterprise risk, or idiosyncratic risks with the investment.

b. <u>20 Year Treasury Note.</u>

If the 30-day Treasury Bill was instead a 20 year Treasury Note, two new risks emerge. First, there is a longer period of time in which the U.S. government could default on its obligations. This is still a very small risk. Second, there is a risk that interest rates may increase, meaning that the interest rates provided in the bonds are too small. These risks need to be reflected in the pricing of the bond. And they are. A 20-year Treasury Note currently provides interest at approximately 2%, and an intermediate measure of the risk free rate of return.

c. <u>United States Stock Market.</u>

An investment in the United States stock market carries with it risk greater than an investment in the United States government. Accordingly, an investor would want to be compensated for this risk, by having a greater rate of return expected for holding investments in the stock market. Backing out what historically has been the return expected by investing in large capital stocks, the heuristic is that an investor expects 8%, annually, in capital growth (spread over a period of time) for holding stock investments. (Pre the late 90s stock boon, that equity premium was 7.03%. 1995 Ibbotson, cited in *Adams v. Comm'r*, T.C. Memo 2002-80 (2002)).

[47] Risk free here does not mean that the principal is risk free if interest rates change. It means that the income the bond is producing is free of risk.

d. Small Closely Held Business with One Customer.

Investors would look for a sizeable rate of return here, in excess of 15, 20%.

Heuristic: Use comps as starting point for EBITDA multiple, but adjust for business reality.

EBITDA multiples can be determined by reference to public companies.

For example, let's go back to the common sense concept. There is always much talk about the stock market, with public companies trading at 15 to 20 times earnings, and some even greater.[48] Intuitively, we may be thinking that a comparison to public companies will result in the multiples being this high.

But EBITDA will be greater than earnings. Interest on debt is added back to earnings; depreciation is added back to earnings; amortization is added back to earnings; taxes are added back.

As EBITDA increases, the price/earnings multiple decreases. So we should see this expected 15 to 20 be decreased to 8 to 15 as the appraiser adjusts public companies multiples on an EBITDA basis.

Then, adjustments can be made based on differences between the public company and the private business being valued. Two variables that impact multiples are risk and growth. Investors pay more for growing companies with lower perceived risk. For example, larger billion dollars in revenue companies are more diversified, have greater access to capital, can be more profitable, and are perceived to be less risky than small $100 million closely held businesses. The publicly traded billion dollar company also typically has greater growth projections.

Another example of divergences is in manufacturing. Manufacturing companies typically trade at lower multiples (e.g., 4 or 5x EBITDA) because they are subject to more risk (e.g., automotive suppliers getting squeezed for price reductions, give-backs, and so on.), and are typically more asset intensive. By being more asset intensive, more cash flow needs to be reinvested to support capital expenditures to achieve growth, or simply to stay in business. Investors will pay a lower EBITDA multiple for a company that is constantly replacing fixed assets.

Heuristic: There is always a good story as to why the Multiples Should Be Lower, or the Discount Rate Higher. Drop your anchor at a good starting point.

Comparables can be too high because there is risk related to a specific company, to the industry, location is in US, the size of the company (too small, cannot compete with big guys; too large, not flexible enough to change to changing environment) or it lacks growth.

Specifically by way of example, publicly traded companies may be growth oriented (food, drugs, health related services), and a reduction can be made there because the subject company is not in growth mode. Or the public companies can be greater capitalized, larger, and therefore less subject to idiosyncratic risk.

[48] As an aside, a Company trading at 40 or 50 times earnings is truly expected to grow, essentially double its earnings, very quickly. If earnings are doubled, that Price to Earnings ratio will in essence be halved.

These differences can further adjust the EBITDA multiple down to around 4 to 6.[49] Perhaps this is why courts do not like this metric. At 4 to 6 times EBITDA, companies often have attractive valuations for our GRAT and sales strategies.

Heuristic: Really Focus on Obtaining and Justifying the Highest Discount Rate.

If an investment is to be valued by using a cost of capital (discount rate) to discount future cash flows, there needs to be an assessment of what that discount rate should be. The closely held operating business is intuitively more risky than an investment in publicly traded stock. First, it is an investment in one business (not a diversified portfolio), has idiosyncratic risk associated with its own business, usually is capitalized at the lower end of the spectrum, and lacks ready marketability. All of these variables need to be taken into account in determining the discount rate used to value future expected cash flows.

Courts seem to be enamored with a discount rate tied to a "weighted average cost of capital," a capital formation based on a percentage of equity and a percentage of debt. Using debt in the equation reduces the risk (debt is cheaper than capital), and therefore the discount rate.

One could argue that if a Company has no debt, that the discount rate should be tied merely to the risk of equity. In that equation, it would work as follows.

For an operating company (other than a real estate holding company), this typically starts with the risk free rate of return (proxied by the 10 year return on Treasury Notes), plus the stock market equity premium (e.g., 7 to 8%). *See, e.g., Gross v. Comm'r*, T.C. Memo 1999-254.

Thereafter, the valuation needs to either justify additional risk factor components, such as company specific risk (e.g., small customer base), small capitalization risk premium, or built-in liabilities; or use a more generic model, such as a weighted average cost of capital,[50] that takes into account more generic pricing based on the company's expected movement with the stock market, and its lower, after-tax cost of borrowing. Courts are not consistent in which method they will accept over another. *Cf. Gross, infra*, with *Adams v. Comm'r*. T.C. Memo 2002-80.

Example: An S Corporation manufactures cleaning supplies and has net revenues of $20M, and free cash flow of $2,000,000. It has three major customers that account for 90% of its revenues. In valuing future cash flows, assume that each of these risk factors is additive. The buyer looks at the cash flow, and conservatively estimates that it can continue at the current rate but will not increase. But that continuation is based on a number of factors. One is the idiosyncratic problems represented by the specific business: will that business continue operating as well under a new shareholder arrangement? Assume that the buyer requires a 5% return to account for that risk. Another is that it is an operating company, and all operating companies can be affected by macro concerns. The stock market has, as noted above, traditionally returned 8% on large capital stocks, and therefore has impliedly created a desired 8% return on stock. Small capitalization stocks have often

[49] *See, e.g., Furman, supra*, in which the Court denied the taxpayer's expert's multiple of 5 times EBITDA, and instead adopted a 6 times EBITDA multiple.

[50] Courts tend to prefer the weighted average cost of capital approach, WACC, over a pure cost of capital with no debt. *See, e.g, Heck, infra.* However, if the Company had no debt structure, than there is an argument that WACC is not appropriate, and the discount rate should be based on an all equity cap structure. That argument is consistent with valuing an S corporation without tax adjusting; that is, looking at the structure of the seller, and not what a buyer would transmogrify the structure to be after the purchase.

yielded an additional 4% premium over large capital stocks because of the greater risk associated with small cap stocks continuing. And with only three customers accounting for a majority of its business, this could be a substantial problem if one customer were to leave. The investor requires a 4% risk premium to account for that risk. And finally, the investor could invest in 10 year treasury notes, essentially at a risk free rate of 2% or 3%, so that should be the benchmark for which it starts its investments. The sum of these is 24%, so the investor could value this company at a 24% cost of capital (or 4 about times expected cash flow).

Building a discount rate based on WACC is by reference to an optimal or industry capital structure (let's say 60% equity, 40% debt). The reason for using the industry capital structure is that it allows you to compare apples-to-apples value indications derived from the DCF Method and the Guideline Public Company Method, which allows for an easier reconciliation process. But is this the anchor you want dropped in your valuation report?

Heuristic: Focus on where the anchor is dropped for the multiple or discount rate.

7. Adjust EBITDA and Cash Flow

Heuristic: Pick low hanging fruit when adjusting and reviewing variables in a DCF or EBITDA valuation.

There are certain adjustments that one can focus on that will adjust valuations correctly (lower), are reasonable, and will anchor the valuation where one wants it to be anchored.

For EBITDA, the key here is the term earnings. Are earnings trending up, or down, and what is one's starting point for earnings.

Example: Boffo Manufacturing has 2012 earnings of $1,250,000; 2013 earnings of $1,500,000, and 2014 earnings of $2,000,000. In determining the E in EBITDA, what would you like your starting point to be? An average versus the last year is preferable. Is Management justifying an average.

Example: Assume Boffo in the above example has earnings in reverse, $2,000,000, $1,500,000, and $1,250,00. Starting point? Preferably the last year.

Also for EBITDA, make sure salaries and other costs look right and can be justified, so that they are not added back to earnings and do not thereby cause a higher starting point. In many instances, there will be some add back.

For Free Cash Flow (DCF), if there is a pro forma of future cash flows, or current cash flow is normalized, how can cash flow be reduced? Capital expenditures for new equipment, increase in costs and salaries, hidden liabilities, increase in uncollectable account receivables are all examples.

Example: Taxes, Waxey, and Wise law firm has generated NIPP (net income per partner on a cash basis) of $450,000, and overall free cash flow its last three years of $4,000,000, $4,300,000, and $4,600,000 respectively. What is the law firm's value? One way to determine this is to look at its last year, $4,600,000 of free cash flow, and do a projection of free cash flows for the succeeding two years. Assume they result in cash flow of $4,300,000 (substantial capital expenditures in technology are expected in the first year), and then $5,200,000. Assume that cash flow is then expected to grow at 4%, and that given the competitive nature of the law industry, and expected new legislation and competition, these cash flows are quite risky, that is, riskier than the stock market, plus the small corporation premium. Assume that a cost of capital at 15% is arrived at by this analysis. Assuming last year's cash flow of $4,600,000 was not yet distributed to partners, the valuation of the law firm is: 4.6M/1.15 + 4.3M/(1.15)^2 + 5.2M/1.15^3 + (5.2M/(.15-.04))/1.15^3.

Heuristic: EBITDA and DPV are only the beginning of the valuation date. We still need to close it out by reference to the balance sheet.

Value based on EBITDA or DPV is the beginning and close to the end. But not the end. For us, the adjustments that should be made are three fold, balance sheet adjustments, tax adjustments, and discounts for illiquidity and lack of control (and other schtuff, like key person and the " I need to be paid more so I am making this us" discount).

Heuristic: Logic controls on balance sheet adjustments.

There are really only certain adjustments that should be made on the balance sheet. One is excess cash. If there is cash that is not needed for fund the business, that is excess cash and should be added to value. Ponder the justification that cash and marketable assets on the balance sheet are needed as working capital (the obvious is to figure out 3 month expenses and indicate the Company needs that reserve; or 6 months; or perhaps the Company is international and needs marketable assets to hedge currency risk; or assets are needed to manage commodity price risks; and so forth).

Another obvious adjustment is debt. That should be subtracted from the arrived at value.

How about PPE (property, plant and equipment)?

Good will?

Takeaways #12: Math For Dummies/Lawyers.

Used to be we could just practice law and occasionally argue about the level of minority or marketability discount. The reality now, regardless of what happens with the 2704 regulations, is that we have to be versant with the ins and outs of valuation methodologies." There's gold in them there hills," is one way to look at it.

And even with the hoopla about the proposed regulations and 2704, and recent rather unpleasant inquiries (at the Tax Court level) of sales to grantor trusts, planners going forward need to continue to focus on grantor retained annuity trusts, a go to strategy.

XII. Don't Ignore the Tax Planning Gorilla in the Corner of the Strategy Room.

A. Since 1990. The grantor retained annuity trust (GRAT) has been statutorily authorized since 1990 and has been advocated as an effective transfer tax technique since that time. But the GRAT has not traditionally been the paramount estate tax reduction strategy, often being supplanted by family limited partnerships, or sales to grantor trusts. But a number of events in past years have acted to accelerate the importance of this strategy in the estate planner's environment, in fact, perhaps as a go-to advanced estate tax strategy of first choice. These events include the following, the *Strangi II* decision (and its progeny) and the *Walton* case (and subsequent IRS acquiescence in it), the *McCord* case (and what it may or may not mean), the IRS reaction to tax shelters in the income tax area and subsequent fallout in the estate tax area, and the continuing low section 7520 rate.

B. GRATs Generally

A GRAT is created by transferring one or more assets into an irrevocable trust and the grantor retaining the right to an annuity interest ("a qualified interest") for a fixed term of years. When the retention period ends, assets in the trust, including all appreciation, pass to the named remainder beneficiaries. GRATs provide a fixed annuity payment, usually expressed as a fixed percentage of the original value of the assets transferred in trust. For example, if $100,000 is placed in trust and the initial annuity payout rate is 6 percent, the trust would pay the Grantor $6,000 each year, regardless of the value of the trust assets in subsequent years.[51]

All income and appreciation in excess of that required to pay the annuity accumulate for the benefit of the remainder beneficiaries. Consequently, it may be possible to transfer assets to the beneficiaries when the trust terminates with values that far exceed their original values when transferred into the trust and, more importantly, that far exceed the gift tax value of the transferred assets.

Because family members are typically involved, the gift tax valuation rules of Section 2702 typically apply. Section 2702 was enacted to correct valuation abuses associated with grantor retained income trusts ("GRITs"). These rules mandate, in addition to the fixed annuity amount discussed above, the use of a discount rate based on 120-percent of the applicable federal midterm rate ("the 7520 rate") for the month in which the trust is created.[52]

The gift tax value of the transferred assets is determined at the time the trust is created and funded using the "subtraction method." In other words, the value of the annuity interest the Grantor retains is subtracted from the fair market value of the assets the Grantor placed into the trust to determine the amount of the Grantor's gift.[53] A retention of a right determined by reference to the income, a GRIT, or a contingent reversionary right to trust corpus is for gift tax purposes valued at zero.[54] Only "qualified interests" will be valued, which consist of (1) a fixed amount payable at least annually, a GRAT, (2) an amount payable at least annually which is a fixed percentage of the fair market value of the trust's assets, a GRUT, or (3) a noncontingent remainder interest if all of the other interests in the trust consist of interests described in (1) or (2).[55]

C. Structuring the GRAT to Take Advantage of the Section 7520 Rate Hedge

There are two variables that need to be determined in each GRAT, the length of the retained interest (the "length"), and the amount of the annual annuity (the "amount"). The longer the term and the larger the amount, the lower the value of the remainder interest, which is the taxable gift. For example, a three year GRAT, at a 7520 rate of 5%, needs to return to the grantor 36.72% each year in order for the remainder interest to be zero.

The amount and the term define the taxable gift. It is best to structure all these elements together in order to avoid **any** taxable gift exposure. By so doing, this creates a hedge that the rate of return will turn out to be lower than the 7520 rate. In other words, if the rate of return of the GRAT is less than the 7520 rate then there is a transfer tax loss, that is, the grantor would have been better off making a straight gift of the discounted present value of the remainder interest. But if the straight gift is zero, because it is structured so that the remainder interest is zero, there can be

[51] If income earned on the trust assets is insufficient to cover the annuity amount, the payments would be made from principal.
[52] The 120 percent applicable federal midterm (Section 7520) rate changes monthly and is reported in Revenue Rulings by the IRS in Table 5 and in various financial news publications such as *The Wall Street Journal*. Additionally, the IRS provides this information online at http://www.irs.gov/taxpros/lists.
[53] Section 2702(a).
[54] Section 2702(a)(2)(A).
[55] Section 2701(a)(2)(B), 2701(b)(1-3).

no transfer tax loss. [56] But that transfer tax loss can be eliminated by structuring the GRAT as a so-called "zeroed out GRAT" for transfer tax purposes. Specifically, the grantor retains an annuity amount large enough so that there is no gift tax element in the remainder interest. In that way, if the rate of return of the GRAT is less than the 7520 rate, then there is no transfer tax gain, but there has correspondingly not been a gift (so only the administrative costs and opportunity costs are lost).

Example: The grantor transfers $1,000,000 in securities to a 3 year GRAT. The 7520 rate in effect at the time of transfer is 5%. The grantor retains the right to $367,200 from the GRAT per year for three years. The discounted present value of the remainder interest is zero. No gift is reported. If the GRAT experiences a rate of return in the GRAT of less than 4% annually, at the end of three years, all GRAT property has been returned to the grantor and there is no transfer to the remainder beneficiaries. If the GRAT experiences a rate of return of greater than 4%, there is transfer tax gain. Assume the annual return on the GRAT, before tax, is 6%. At the end of three years, approximately $21,000 remains to pass to the remainder beneficiaries, and no taxable gift has been made. See attachment 3.

D. <u>I Choose Door Number 2: GRATs with no Taxable Gifts as an Alternative to Sales</u>

1. <u>Zeroing Out</u>

Zeroing out GRATs for gift tax purposes should have been achievable since 1990. The valuation of the retained interest is a straightforward discounted present value of an annuity for a term of years. The term of years should pay out in the GRAT regardless of whether the Grantor is living or has died during that time. If the Grantor dies during that time, the remaining annuity interest should be paid to his estate. In this way, the value of the annuity will not be based on any life expectancy issues.

But from 1990 through 2000, the IRS did not see it that way. For trusts implemented after January 28, 1992, the regulations introduced and applied (and strongly implied) that a life expectancy factor was required, the so-called example below to the Regulations. The question was whether the actuarial assumptions mandated by the following example in the Regulation to Section 2702 were valid. If valid, then a GRAT could not be zeroed out and there would always be transfer tax risk if the GRAT did not outperform the 7520 rate.

2. <u>Example</u>:

The Treasury Regulations currently provide that a GRAT will always have a remainder interest.[57] Thus, there will always be a gift to the remainderpeople. Support for the Service's position that there must always be a gift to the remainderpeople found in an example purportedly based on the text of the Regulations. "The governing instrument must fix the term of the annuity or unitrust interest. The term must be for the life of the term holder, for a specified term of years, or for the shorter (but not the longer) of those periods."[58] The Regulations then provide an illustration. The illustration provides that when an annuity is retained for a term of years, assuming the annuitant dies within the stated term, and the

[56] Mathematically, 0 * any rate of return is still 0. And the GRAT can never be a negative number; that is, there can be no lingering obligation by the grantor to pay money over that the GRAT does not have.

[57] The Preamble to the Treasury Regulations is consistent on this point. "The proposed regulations prohibited increases to prevent transferors from "zeroing out" a gift while still effectively transferring the appreciation on all the property during the term to the remainder beneficiary, (e.g., by providing for a balloon payment in the final year of the term). The Treasury Department and the Service believe that such a result would be inconsistent with the principles of section 2702." Preamble to T.D. 8395, 1992-1 C.B. 316, 319

[58] Regulation 25.2702-3(d)(3) (emphasis supplied)

annuity is then paid to the annuitant's estate, the valuation of the annuity is not based on the stated term. Instead it is valued for the term of years or the annuitant's prior death.[59]

According to the Service, only the value of an annuity payable for the shorter of the stated term or the period ending upon the annuitant's death may be subtracted from the fair market value of the property contributed to the irrevocable trust in calculating the value of the taxable gift. If this Regulation is correct, there would always be a taxable gift for every GRAT because every annuitant has some risk. The value of that mortality risk would, in every case, represent a taxable gift to the remainderpeople.

3. The *Walton* Case

The litigated question in *Walton v. Commissioner*, [60] was whether the Regulation illustrating the calculation for a retained term was a valid interpretation of Section 2702. The initial value of the property transferred in the *Walton* case was just over $200,000,000. If the Regulation was valid, the gift would be several million dollars but otherwise the gift would be a few thousand dollars.

In a reviewed decision by the full Tax Court, the Regulation was held to be an invalid interpretation of Section 2702.[61] The Court primarily looked to the statute itself.[62] The Court reasoned that if it had sustained the IRS position then Congressional intent, found in 2702, would have been frustrated because no taxpayer would have been able to create an annuity for a term of years that would be valued as such.[63]

Although reluctant to do so, the Service has now acquiesced in the Walton decision.[64] Zeroed out GRATs can be structured without the preceding example overhang. This is a tremendous impetus to the use of GRATs, because now highly volatile investments, capable of substantial returns in excess of the 7520 rate, can be put in the GRAT without concern, from a transfer tax standpoint, of these assets severely dropping in value. [65]

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[59] "EXAMPLE. A transfers property to an irrevocable trust, retaining the right to receive 5 percent of the net fair market value of the trust property, valued annually, for 10 years. If A dies within the 10-year term, the unitrust amount is to be paid to A's estate for the balance of the term. A's interest is a qualified unitrust interest to the extent of the right to receive the unitrust payment for 10 years or until A's prior death." Treas. Reg. 25.2702-3(e)
[60] 115 T.C. 589 (2002). The *Walton* case was litigated in the United States Tax Court.
[61] *See Walton v. Commissioner*, 115 T.C. 589 (2000).
[62] (b) Qualified interest. -- For purposes of this section, the term "qualified interest" means -- (1) any interest which consists of the right to receive fixed amounts payable not less frequently than annually, (2) any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and (3) any noncontingent remainder interest if all of the other interests in the trust consist of interests described in paragraph (1) or (2). Section 2702(b)
[63] "[T]here exists no rationale for refusing to take into account for valuation purposes a retained interest of which both the form and the effect are consistent with the statute. We further observe that respondent's attempts to equate the estate's rights here with other contingent, post-death interests are premised on the bifurcation of the estate's interest from that of petitioner. Yet, given the historical unity between an individual and his or her estate, we believe such separation is unwarranted where the trust is drafted in the form of a specified interest retained by the grantor, with the estate designated only as the alternate payee of that precise interest. This is the result that would obtain if the governing instrument were simply silent as to the disposition of the annuity in the event of the grantor's death during the trust term. Additionally, any other construction would effectively eliminate the qualified term-of-years annuity, a result not contemplated by Congress." *Walton v. Commissioner*, 115 T.C. 589 (2000)
[64] Notice 2003-72 (2003).
[65] That the interest retained by the Grantor is expressed as a fixed percentage or fixed amount, and not subject to contingencies other than as to time of retention and time of payment, then the amount retained will be a qualified interest regardless of the volatility of the asset or the potential for transfer tax savings. This is true regardless of

E. GRATs with No Taxable Gifts as an Alternative to Sales: The Shifting Tide

Even in light of the ability to use a GRAT as an estate tax reduction strategy, the GRAT still lagged behind the "sale to a grantor trust" strategy ("sale") as the go-to strategy of choice in the late 1990s. Part of this was due to the uncertainty of the ability to zero out GRATs pre *Walton.* But most of it was due to the superior flexibility of the sale strategy over the GRAT strategy.

The major structural advantage of the GRAT over the sale technique is that the GRAT is statutorily authorized. If a practitioner follows the section 7520 rules, the risks of the GRAT are the idiosyncratic ones, e.g, the grantor does not live the retained term, the assets underperform the 7520 rate, or the assets are improperly valued going in. But the risk is not structural. If properly created, a GRAT will not result in a taxable gift even if the valuation is later adjusted by the Service.

Example**:** Alluding to the technique discussed and impliedly accepted by the Tax Court in the *Kerr* case,[66] client sets up a limited partnership with assets worth $5,000,000. Assume the client has already used all of her gift tax exemption. 90% of the partnership is represented by limited partnership interests. The taxpayer discounts the value of these limited partnership interests by 40%, substantiated by a thorough and specific appraisal. The value of the limited partnership interests are thus $2,700,000; and are transferred to a 5 year GRAT during a period in which the 7520 rate is 5%. The GRAT is zeroed out and the required annual return is $630,000. The Partnership experiences a 14% annual rate of return and distributes the entire rate of return (14%) to the GRAT. The GRAT uses 90 % of this 14%, or $630,000, to make the annuity payment to the grantor. At the end of 5 years, the remainder beneficiaries have 90% limited partnership interests with a liquidation value of $4,500,000 (and a fair market value, with discounts, substantially less than this). This was achieved at no transfer tax cost.

Assume the IRS pursues and successfully reduces the discount from 40% to 20%. The net effect is that the GRAT is required to pay to the grantor $831,000 per year versus $700,000. Back payments, plus interest, are owed to the grantor. But there is no gift tax readjustment. The net value of the technique is reduced by this reduction, but there is still value and still no gift tax cost.

In contrast, the sale technique is not statutorily authorized. If the sale technique is not recognized by the IRS (or courts), and there is a valuation readjustment, there could be substantial gift tax concerns.

F. Investments within GRATs as Part of the Overall Prudent Investor Rule

Investments within GRATs take on a very interesting dynamic in light of the *Walton* case and IRS acquiescence. Not enough attention has been spent in recent years emphasizing what should be invested in GRATs. The context gets confused, however, because there are so many excellent investments within a GRAT, and the analysis really becomes one of a hierarchical nature.

For example, consider a client worth $10,000,000 that contributes $1,000,000 in cash to a zeroed out GRAT at a 7520 rate of 2%. There is no preconceived plan to have the GRAT buy assets from the grantor, but shortly after establishment, the trustee of the GRAT determines to do just that. Which assets should the trustee purchase from the grantor?[67]

1. $1,000,000 worth of treasury notes with an interest crediting rate of 5.

2. $1,000,000 worth of preferred stock paying 7%.

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what the GRAT invests in and regardless of the remoteness of the GRAT paying out the annuity amount because of the riskiness of the GRAT's investments.

66 292 F.3d 490 (2002).

67 These should be no income tax on the exchange because the GRAT is a grantor trust.

3. $1,000,000 worth of stock in a large cap index fund (e.g., S & P 500 Fund with Vanguard). Note that at the end of 5 years, $114,298 is transferred to the children free of gift tax if the stock appreciates at 8% annually, on an average basis.

4. $1,000,000 worth of pre IPO stock that is expected to double in value in 2 years at the IPO offer.

5. $1,000,000 worth of private equity that is expected to earn 30% annually.

Takeaway #13: The Moral of the story.

The moral of the story: invest in volatility (or assets with a high discount rate in valuation versus before cash flow generated) within the GRAT to the extent the grantor would ordinarily be invested in those types of assets.[68] In a worst case scenario, the GRAT yields no transfer tax savings because there has been no increase in value. However, in other scenarios, substantial transfers will have occurred.

G. Creative uses of the GRAT

Once the zeroed out GRAT concept is accepted and the importance of GRAT planning understood, the GRAT itself becomes an interesting technique to iterate. For example, if, as in the *Kerr* case, the GRAT is funded by limited partnership interests, these partnership interests are discounted going into the GRAT. The effect of the discount is to lower the hurdle rate required for the GRAT to be transfer tax efficient. For example, if the 7520 rate is at 5%, an asset that is discounted by 40% and used to fund the GRAT will require a rate of return, before tax, of only 3% to achieve a transfer tax gain.[69]

In addition to discounted assets, can the GRAT portfolio consist of the grantor's most volatile assets? The answer is clearly yes under the current regulations to section 7520.

Operating businesses in the S Corp or LLC format are perfect candidates for GRATs.

Further, the grantor must pay the income tax on the GRAT during the retained term. This is both required and a positive net cash flow result to the GRAT. The payments by the GRAT to the grantor are in effect the payment of an after income tax obligation (to the grantor) with before income tax dollars. After the retained term, the grantor trust status can be continued in order for

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[68] The trustee has broad authority to engage in investments as set forth in the trust. That authority is circumscribed by the terms of the trust, not federal law. *Morgan v. Commissioner,* 309 U.S. 78, 60 S.Ct. 424, 84 L.Ed. 1035 (1940). *See also Brantingham v. United States*, 631 F.2d 542, 545 (7th Cir. 1980)("[A] determination of the legal rights and interests created by an instrument is a question of state law.") If the trustee is authorized to engage in investments that include private equities and other riskier (versus traditional publicly traded stocks) investments, that investment authority is permissible, despite the riskiness or volatility of the investment. A standard that is typical in most documents is as follows:

> "In addition to all powers granted by law, the trustee shall have the following powers, to be exercised in a fiduciary capacity: To invest in bonds, common or preferred stocks, notes, options, common trust funds, mutual funds, shares of any investment company or trust, or other securities, life insurance, partnership interests, general or limited, joint ventures, or other property of any kind, regardless of diversification and regardless of whether the property would be considered a proper trust investment…."

Section 2702 by its specific terms requires that section 7520 applicable federal rate be used to value interests in GRATs. Therefore, despite a strong logical reasoning not to apply the 7520 rate to discount future cash flows that are based on assets with higher volatility and risk patterns than the 7520 rate, the statute requires the 7520 rate to be used. *See* 2702(a)(2)(B).

[69] 5% multiplied by the 40% discount.

the grantor to continue to pay the income tax related to the GRAT assets. These results were recently affirmed, in sort of a backhanded way, by the Service. The question has been raised as to whether the payment by the grantor of income tax, as mandated by law, is nevertheless a gift by the grantor to the trust. The IRS in Revenue Ruling 2004-64 ruled "no," that there is no gift if the grantor pays the income tax. But the Service required care here. A gift could occur:

"If, pursuant to the trust's governing instrument or applicable local law, the grantor must be reimbursed by the trust for the income tax payable by the grantor that is attributable to the trust's income, the full value of the trust's assets is includible in the grantor's gross

Takeaway #14: The tide comes in/the tide goes out.

The tide has come in for GRAT planning as an estate planners first sophisticated planning strategy of choice. Structuring advanced estate tax strategies with GRATs should be considered because of the statutory authorization and ability to reduce readjustment risk as to valuation, and because of the extreme discrepancy (transfer tax arbitrage) between the required use of the risk free section 7520 rate in valuing GRATs, and the return or volatility rate of the underlying GRAT investments. As presentations this week demonstrated, GRATs can be used effectively not only for businesses with cash flow, but for marketable securities and most other assets (other than cash and bonds). We should embrace creativity when we think about the possibilities for this statutorily authorized transfer tax technique.