Enhancing The Planning Value Of GRATS, SCINS, And IDITS

Alexander Law Offices, S.C.
933 N. Mayfair Road, Suite 301
Wauwatosa, WI 53226

(414) 476-5020 Fax: (414) 476-5089

bob@alexander-klemmer.com

Robert G. Alexander, JD, LL.M., AEP, EPLS

Biography

Attorney Robert G. Alexander is the President and majority shareholder in the law firm of Alexander and Klemmer, S.C., located in Milwaukee, Wisconsin. He entered private practice in 1978, and concentrates his practice in the areas of estate planning and advising family businesses, including federal estate and gift taxation, trust and estate administration, fiduciary income taxation, life insurance planning, retirement planning, charitable planning, business organization and succession planning. Attorney Alexander is a graduate of the University of Wisconsin - Madison (B.A. English, 1971), the University of Wisconsin-Madison Law School (J.D., 1976), and DePaul University (LL.M. taxation, 1984). He is admitted to practice before all courts in the State of Wisconsin, the U. S. Federal Courts for the Eastern and Western Districts of Wisconsin, the Seventh Circuit Court of Appeals and the U.S. Tax Court. He is a member of the American Bar Association sections on Real Property, Probate and Trust Law and Taxation; the State Bar of Wisconsin; the National Association of Estate Planners and Councils; the Milwaukee and Waukesha Estate Planning Councils; the National Academy of Elder Law Attorneys; the National Committee on Planned Giving; the Planned Giving Council of Eastern Wisconsin; and the Society of Financial Service Professionals. Attorney Alexander serves on the Board of Directors of the National Association of Estate Planners and Councils (NAEPC) and the Milwaukee Estate Planning Council. He has earned designations as a Board Certified Estate Planning Law Specialist (EPLA) as accredited by the American Bar Association and as an Accredited Estate Planner (AEP) by the NAEPC. He is currently Publishing Editor of the NAEPC's academic journal, _The NAEPC Journal of Estate and Tax Planning._ Attorney Alexander serves on the NAEPC committee administering the Accredited Estate Planner designation and is on the Board of Directors of the Estate Planning Law Specialists Board, Inc. Currently he is chairperson of the NAEPC Professional Development and Education Committee, and is an NAEPC representative to the Synergy Summit, a leading national estate, tax and financial services think tank, where he also serves as the Chair-Elect. Attorney Alexander is a nationally known speaker who lectures and teaches extensively for both public and private organizations including attorney continuing legal education, the Wisconsin Institute of CPA's, major insurance companies, brokerage firms, banks, trust companies, charitable organizations and various local colleges. Recent professional continuing education courses taught by Attorney Alexander include *Estate Planning for Owners of Closely-Held Business Interests* (2day seminar); *Integrating Wealth Transfer Strategies-The Modular Approach to Estate Planning* (2 day seminar with Attorney Mark Merric of Denver, Colorado); *Planning with Domestic and Foreign in Asset Protection Trusts; Tax and Estate Planning with Dynasty Trusts; Financial Modeling to Supercharge Lifetime Estate Planning Techniques; Enhancing the Planning Value of GRATs, SCINs and IDITs; Designing More Flexible Life Insurance Trusts; Estate, Tax and Asset Protection Planning Using Limited Liability Companies; Lifetime and Testamentary Charitable Planning; Tax and Estate Planning Under the 2001 Tax Act; Post-mortem Trust Administration; Practical Estate Planning and Drafting After the 2001 Tax Act; Practical Medicare and Medical Assistance Skills in Wisconsin*; *Trust Administration and Trustee Selection*; *The Nuts and Bolts of Trusts in Estate, Tax and Financial Planning* and *Wisconsin Estate Planning and Drafting Fundamentals.*

IMPORTANT DISCLAIMERS AND NOTICES

These materials are intended for educational purposes ***only***. They are designed to provide accurate and authoritative information in regard to the subject matter covered. However, Attorney Robert G. Alexander is not offering legal, accounting, or professional advice in these materials. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.

The forms and sample language have been developed and are included herein exclusively for purposes of illustration and discussion and are not designed or intended to be utilized (or adapted for uses) in any Will, Trust or other dispositive instrument.

No claim is made to original work herein. These materials include a compilation, summary, revision, and commentary from other source material, most of which is cited in the bibliography.

IRS Circular 230 Disclosure:

To ensure compliance with requirements imposed by the U. S. Internal Revenue Service, we inform you that any tax advice contained in this document (including any attachments) was not intended or written to be used, and cannot be used, by any taxpayer for the purpose of (1) avoiding tax-related penalties under the U. S. Internal Revenue Code or (2) promoting, marketing or recommending to another party any tax-related matters addressed herein.

NAEPC Current Projects

- Providing the highest quality training, education, products and services to America's leading estate planning professionals.
- Increasing public awareness of estate planning and the advantages of using a "team" of qualified estate planning professionals.

I. Academic Programs
   A. LLM Programs
   B. Masters Programs
   C. CLE
   D. Conferences/Webinars/Audio Broadcasts

II. National Estate Planning Conference–Annually Recognized as One of the Nations Leading Estate Planning Conferences

III. Forms/Documents–Blattmachr's Wealth Transfer Planning

IV. Estate and Financial Planning Software

V. Prestigious Publications–NAEPC Journal of Estate and Tax Planning

VI. Newsletters–CCH/Blattmachr/NAEPC

VII. Research Libraries and Technical Information–CCH Publishing

VIII. Leimberg Informational Services/LISI

IX. Nationally Recognized Experts–Speakers/Teachers

X. Networking and Concurrent Projects Among the Nation's Leading Estate and Financial Planning Organizations
   A. NAEPC/Synergy Summit
      1. Society of Financial Service Professionals
      2. American Institute of Certified Public Accountants
      3. American Bar Association–Real Property, Probate and Trust Law Section
      4. American Bar Association–Tax Section/Gift and Estate Tax Committee
      5. NAEPC
      6. NAELA–National Academy of Elder Law Attorneys

XI. Referrals/Networking–Locally and Nationally

XII. Charitable Foundation–Public Awareness and Education Regarding Estate Planning

XIII. National Recognition of America's Most Distinguished Estate Planning Professionals
      1. Distinguished Accredited Estate Planner Awards
      2. Hart Axley Distinguished Service Award
      3. Awards for the Nation's best tax and estate planing articles published during the year

XIV. Nationally Recognized Estate Planning Designations
      1. Accredited Estate Planner Designation (AEP)
      2. ABA Board Certified Estate Planning Law Specialist (EPLS)

XV. Business Exit Planning – BEI - Business Enterprise Institute

ENHANCING THE PLANNING VALUE OF GRATS, SCINS AND IDITS

Robert G. Alexander, JD, LL.M., EPLS, AEP

Estate Planning Challenges

- Planning in an uncertain tax environment
- Estate, asset protection and family wealth planning require proactive planning
- Combine and layer multiple techniques and tools to accomplish optimal results for wealthy families

It's a Whole New Ballgame

- Increased audit scrutiny and IRS litigation strategies
- Recent IRS rulings and court decisions
- New PPA 2006 penalties
- Circular 230
- Chapter 14 valuation rules
- Sec. 6694 preparer penalties

Conceptual Overview
Setting the Stage

- Estate Planning Techniques to
  - Freeze size of Estate
  - Transfer wealth on a leveraged basis
  - Income tax planning
  - Asset protection planning
  - Family wealth management/control

4

Conceptual Overview-Continued

- Mathematics of Planning – sophisticated integration of planning and calculations is critical!
  - Calculation of life expectancies
  - Contingency plan for death of either spouse
  - Living too long
  - Premature death

5

Conceptual Overview-Continued

- Mathematics of Planning-continued
  - Preserving post-tax income
  - Inflation adjusted
  - Health and age
  - Income and death tax contingencies

6

Conceptual Overview - Continued

- Fair market value of assets
- Valuation discounts
- Cost basis
- Term (in years and months) of documents
- Estate and gift tax brackets
- Income tax brackets

7

Conceptual Overview - Continued

- Individual asset growth rates and tax attributes
- Inflation rates
- AFRs – applicable federal rate
- 7520 rate
- Borrowing rates
- Liquid funds rates
- Cash flow needs

8

Conceptual Overview- Continued

- Key! – Develop a Comprehensive Analysis
  - Will it cash flow?
  - Develop mathematical proofs and spread sheets
  - Compare
    - All possibilities
    - All probabilities
    - Risk tolerance
  - Sophisticated Monte Carlo modeling
  - "What if" strategies
  - Hedging your bets
  - Layering the documents and financial/tax strategies
- Create an effective "tax burn"

9

Keep In Mind the Distinction Between

- Estate Planning
  - Wealth planning using lifetime transfers by gifts and sales and transfers at death.
- Business Succession Planning
  - Planning the successful transfer and continuation of a business focusing primarily on the survival of the business.
- Business Exit Planning
  - Planning the successful exit of he business owner from the business focusing primarily on the business owner's needs and personal goals.
- Similar – but different

10

Key Planning Strategies

- Creatively integrate estate, tax, asset protection and financial planning techniques.
  - Select the best entities to use
  - Use valuation discounts
  - Use leverage/freeze strategies
  - Use trusts

11

Key Planning Techniques

- Lifetime Gifts
  - Annual exclusion gifts
  - Applicable exclusion amount gifts
- Dynasty Trusts
- Grantor Retained Annuity Trusts – GRATs
- Intentionally Defective Grantor Income Trusts – IDGITs
- Self-cancelling Installment Notes –SCINs

12

Leveraged Freezes

- Definition – combining valuation discounts with leveraged gift and sale techniques
  - Freeze assets at current value
  - Transfer appreciation to the next generation
  - Transfer less than complete interest in the property
- When to Use
  - Retain Income
  - Retain Some Capital
  - Remove Assets from the Estate
  - Transfer Future Appreciation

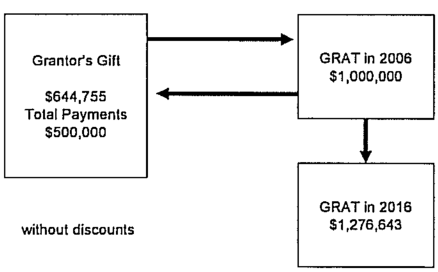
13

GRAT

- Split interest trust
- Grantor retains an annuity interest for a period of time
- At the end of the GRAT term, the trust assets are distributed to the trust beneficiaries
- The gift is the FMV of the assets transferred less the present value of the annuity – Sec. 7520 rate

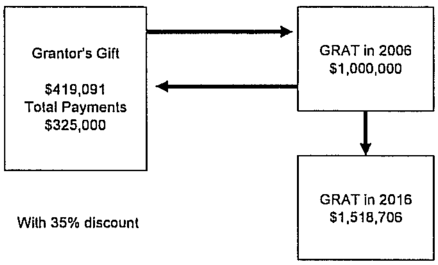
14

Grantor Retained Annuity Trust



15

Grantor Retained Annuity Trust



16

GRATs – Grantor Retained Annuity Trusts

- Very effective estate freeze technique
- Predictable results
  - Statutory creature
- Ideal for high income, high growth assets
- All growth greater than the Sec. 7520 rate goes to the beneficiaries
- Freezes the estate at the Sec. 7520 rate

17

Gift Tax Issues

- Present Interests
- Future Interests
- Exclusion
- Gift is the FMV of the property transferred minus the present value of the annuity interest – Sec. 7520 rate
- The amount of the tax-free transfer is the future value of the assets transferred minus the future value of the assets paid back to the Grantor.

18

Estate Tax Issues

- Grantor Survives the Trust Term
  - No estate tax inclusion
- Premature Death of Grantor
  - Some or all of the trust assets are included in the Grantor's estate
    - Sec. 2036 – part – transfer with a retained interest
    - Sec. 2039 – all - annuity
- Estate Inclusion Issues
- Poor GSTT Planning Technique – ETIP rules
  - You can plan around this issue

19

Increasing the Planning Value of GRATs

- Transfer Rapidly Appreciating Assets to the GRAT
- Property Temporarily Depresses in Value
- Post Transfer IPO
- Valuation Discounts
  - FLPs
  - FLLCs
  - S Corporation Stock

20

Increasing the Planning Value of GRATs – cont.

- Assets with Significant Cash Flow
  - Able to support the annuity payments
  - Assets grow in the trust without the trust paying income tax
  - Increases the appreciation in the trust assets
  - Grantor pays the income tax
    - An additional tax free gift
    - Rev. Rul. 2004-64
    - "Tax burn" in the grantor's estate

21

Increasing the Planning Value of GRATs – cont.

- Don't make GRAT payments with discounted assets
  - Discounted assets transferred into the GRAT
  - Undiscounted assets transferred back to the grantor (payments)

22

GRAT Planning Ideas

- Standard GRATs
- Short Term GRATs
- Re-GRATing/ rolling GRATs
- Zeroed Out GRATs – Walton GRATs
- Cascading or sequential GRATs
- Spousal parallel GRATS
- Staggered term GRATs/multiple GRATs
- GRATs With Different Payout Rates
- Adjust payments
  - Increase
  - Decrease
- Need lots of time to transfer significant wealth

23

Zeroed Out GRATs

- Walton Case
- Little or No Gift Tax
  - Term
  - Rates
  - Asset appreciation
- Must Be a Fixed Term Annuity
- Payments Continue to the Estate
- Issues
  - Marital deduction
  - GSTT

24

Investments for GRATS/GRUTS

- Securities
- Real Estate
- S-Corporation Stock
- Dividend Paying Stock/Income
- Exceed the Sec. 7520 Rate
- Loans

25

GRAT ADVANTAGES

- Income stream to the Grantor – annuity
- Substantial gifts with little transfer tax
- Grantor pays the income taxes
- Reduces the value of the Grantor's estate
- Leverage with valuation discounts
- Safe technique with little risk - statutory

26

GRAT Mathematics

- Difference between the actual rate of return and the Sec. 7520 rate
- Valuation discounts on assets gifted to the trust
- Payment of trust income by the Grantor
  - Allows trust assets to grow without reduction for income taxes

27

Other Issues

- GRATS best with Low 7520 interest rate
- Prohibited Financing
- Death of Grantor During the GRAT Term
- Reversionary Interests
- Grantor Trust Status
- Client—Illustrations
- Comparison of GRATS and GRUTS

28

Advanced Planning Considerations With GRATs

- Solving the GSTT Problems
- Hedging the Economic Risks
- Combing GRATs With Disregarded Entities
- GRATs and Remainder Sales to IDGITs
- Hedging the Mortality Risks
- GRATs and S Corporation Stock
- GRAT/SCIN Technique
- Advanced Wealth Transfer Planning Issues

29

SOLVING THE GRAT/GSTT PROBLEMS

- Remaindermen either give or sell their remainder interests to GSTT exempt trusts for full consideration
  - Transferor is the remainderman not the original grantor
  - Remainderman has transferred his/her entire interest so ETIP rules do not apply
  - Transfer is equal to the present value of the remainder interest
  - GRAT cannot have a spendthrift clause
  - Solving the "two transfers" problem
    - Non-skip persons as beneficiaries of the dynasty trust

30

SOLVING THE GSTT PROBLEM

- GRAT remainder beneficiary should be a grantor trust for income tax and advanced planning purposes
- Remainder beneficiary contracts with the GST exempt trust to sell an amount equal to the value of the remainder interest to the GST exempt trust when the GRAT term ends.
- Transfer the remainder interest to a dynasty trust and have either the original grantor or the remaindermen purchase the remainder interest t its FMV from the dynasty trust just prior to the end of the GRAT term
  - The dynasty trust receives the consideration paid, not the remaindermen

31

SOLVING THE GSTT PROBLEMS

- Remainder interests are transferred to a dynasty trust that owns life insurance on the life of the original grantor
  - Grantor survives – accomplish planned wealth transfer
  - Grantor dies – GST trust explodes
- Use non-skip persons as beneficiaries in a dynasty trust to safeguard GST planning

32

HEDGING THE ECONOMIC RISKS OF GRATS

- GRATS can be subject to volatile swings in asset value destroying GRAT economics
- Increase/decrease the annual payments
  - Increase no more than 20% per year
  - No limit on decreases
  - Use graduated payments to keep payments low in earlier years and allow assets to grow and support the future required payments
  - Use graduated payments to keep up with inflation

33

HEDGING THE ECONOMIC RISKS WITH GRATS

- Use single asset GRATs
- Use rolling/short term GRATs when you expect the payments to be made "in kind"
  - Watch under-performing GRATs in early years
- Grantor purchases under-performing assets from the GRAT and re-GRATs them
- Lock in growth by purchasing the assets or have the grantor purchase the remainder interests from the remaindermen
  - Income tax free
  - Protects the locked in gain from the mortality risk

34

PLANNING CONSIDERATIONS WITH DISREGARDED ENTITIES

- Problem when payments have to be made "in-kind" – vastly reduces the wealth shift
- Use a single member LLC
  - Disregarded for income tax purposes
  - Separate entity for transfer tax purposes
- Transfer the non-controlling LLC interest to the GRAT

35

PLANNING CONSIDERATIONS WITH DISREGARDED ENTITIES

- Owner can retain the controlling interest in the LLC
- Design the GRAT so that payments increase over time
- When cash flow is insufficient to make GRAT payments, grantor purchases assets from the LLC
- LLC makes distributions to the GRAT to make the payments

36

PLANNING CONSIDERATIONS WITH DISREGARDED ENTITIES

- Grantor is purchasing assets from the LLC, not discounted LLC interests – no valuation problems
- Discounted gifts to the GRAT – repurchase without discounts
- GRAT is a grantor trust and the LLC is a discounted entity – therefore no income taxes

37

COMBINING THE GRAT WITH REMAINDER SALES TO IDGITS

- GRAT remainder beneficiary is a grantor trust (IDGIT)
  - Sale between the remaindermen and the IDGIT is income tax free
  - Both trusts are grantor trust for income tax purposes

38

GRATS and S CORPORATION STOCK

- GRAT must be an eligible S stock shareholder
- Trust must also qualify as a GRAT (grantor trust for income tax purposes)
  - Grantor must be treated as owning all of the income and corpus of the trust
  - Sec. 675(4)(c)- grantor holds a non-fiduciary power to substitute assets of equal value
  - Sec. 673 – retention of a contingent reversionary interest
  - Sec. 677(a) – trust property is or can be distributed to the grantor or held for future distribution to the grantor

39

GRATS and S CORPORATION STOCK

- Problem with low or no income producing stock
  - Gift tax value can be reduced
  - IRS can ignore the valuation tables and use a more realistic means of determining value
    - Draft a provision giving the grantor the right to compel the conversion of unproductive property to productive property.
    - Does the non-exercise trigger a gift to the remaindermen?

40

The GRAT/SCIN TECHNIQUE

- The SCIN is used to hedge the mortality risk of the GRAT
- GRAT sells assets to his/her beneficiaries using a SCIN in the amount of the GRAT's appreciated assets that may be included in grantor's gross estate
- Two separate transactions
- Estate inclusion of the GRAT is offset by the estate exclusion of the SCIN

41

MITIGATING THE GRAT MORTALITY RISK

- Draft the GRAT so that the continuing payments and the remainder interests qualify for the marital deduction to the extent GRAT assets otherwise would be included in grantor's gross estate – see: Walton GRATs
  - Marital deduction either can be outright or a QTIP
  - Both the annuity interest and the remainder interest must be structured to qualify as deductible terminable interests
- Use multiple GRATS
  - With different terms
  - Higher payments in earlier years and reduce payments in later years. This will reduce the amount of the taxable gift.

42

MITIGATING THE GRAT MORTALITY RISK

- The term of the retained interest can be based on the join lives of the grantor and grantor's spouse.
  - Avoid a taxable gift to spouse by retaining the right to revoke the survivor interest
  - The survivor's annuity probably doesn't qualify for the marital deduction

43

MITIGATING THE GRAT MORTALITY RISK

- Walton GRATS – a fixed term annuity which must continue to the grantor's estate.
- Grantor makes a specific bequest of the annuity payments to the surviving spouse.
- The annuity interest must be made to the surviving spouse either as an outright specific bequest or made to the surviving spouse's estate
- Don't over fund the marital bequest – divide the bequest into two shares
  - one that qualifies for the marital deduction and one that does not
  - just like QTIP drafting

44

ADDITIONAL PLANNING CONSIDERATIONS

- Fixed term GRATS remove the contingency of the grantor's death from the actuarial calculation of GRAT values.
- Mathematical comparisons of direct gifts vs. gifts to GRATS
  - Compare the gift tax on a direct gift vs. GRAT
  - Compare possible estate inclusion
  - Compare investment choices available

45

SITUATIONS WHERE THE GRAT WILL BE SUCCESSFUL EVEN IF THE TOTAL RETURN IS LESS THAN THE 7520 RATE

- Assets transferred to the GRAT are discounted
  - This can work in reverse if the GRAT assets must be used to make the GRAT payments
- The "total return" is the blended rate over the term of the GRAT.
  - Initial short term losses may be offset by large gains over time
- Husbands and wives can use parallel spousal GRATs to hedge the combined rates of return

46

Accessing the Expected GRAT Performance

- Three factors
  - Likelihood that the grantor will survive the GRAT term
  - Likelihood of outperforming the Sec. 7520 valuations assumptions
  - The grantor must ensure that the retained interest will constitute in whole or in part a "qualified interest"
- Other legal and economic issues

47

Outperforming the Sec. 7520 Valuation Assumptions

- Sec. 7520 valuation assumptions
  - 7520 rate
  - The term of the annuity
  - The timing of the annuity payments
  - The value of the property transferred
- GRAT must earn an average rate of return greater than the 7520 rate to transfer wealth

48

Continued

- Exceptions
  - The average rate of return does not always capture the real economic value to the remainder beneficiaries of the GRAT appreciation
  - The GRAT may out- perform or under-perform one of the other assumptions
- Five circumstances where the average rate of return does not accurately predict the success or failure of the GRAT
  - Discussed on following slides

49

Large Losses Before Even Larger Gains

- Investor don't really care about the timing of the gains and losses
  - They want the average rate of return over time
- GRATS –
  - Early losses can reduce or eliminate the advantage of a high average rate of return
  - Early losses cause the bulk of the property to be returned to the grantor

50

Increasing the Planning Value of GRATs

- Transfer Rapidly Appreciating Assets to the GRAT
- Property Temporarily Depressed in Value
- Post Transfer IPO – watch securities law issues
- Valuation Discounts
  - FLPs
  - FLLCs
  - S Corporation Stock

51

Lock-in Superior Returns by Substituting GRAT Property

- Sec. 675(4)(c) power to substitute assets of equivalent value
- GRAT must prohibit prepayments
- Same result with the "power"
- Possible argument that grantor has retained dominion and control over GRAT property?
  - Trusteed arms length transaction
  - Sell or exchange assets with the grantor

52

Return Earned After the Annuity Becomes Payable

- Payments can be made 105 days after the due date
- Reduces the value of the grantor's annuity and increases the value of the remainder
  - This factor is not included in the valuation rules
  - No increased gift tax liability to grantor
  - Tax free gift of appreciation and earnings during this 105 day period
  - GRAT also may decline in value

53

Premature Death of Spouse

- GRAT terminates earlier than the IRS assumes
  - Don't use a just a term of years
  - Earlier of death or term of years
- Qualified annuity can include a spouse's annuity if the grantor retains the right to revoke it
- Valuation will include both qualified interests

54

Continued

- Brief term of years (or death) for the grantor and a successor term for the spouse
- But – more risk of failure
  - Two conditions for a regular GRAT
    - Survival of grantor
    - Outperforming the 7520 rate

55

Continued

- Four conditions for a spousal annuity GRAT
  - Survival of the grantor
  - Survival of the grantor past the life of the souse
  - Earlier than normal death of spouse
  - Superior performance of the GRAT

56

Continued

- Spousal "parallel" GRATs
  - Give each other a revocable annuity
  - At least one of the GRATs will succeed
  - Sophisticated planning and drafting
  - See: Wealth Transfer Planning
    - Blattmachr drafting system

57

Disparate Valuation Factors

- Valuation discounts on assets transferred to the GRAT
- Non-discounted assets transferred back out or you reduce the performance
- Remainder beneficiaries can receive the difference in the valuations
- But this can work in reverse!

58

Selecting Assets to Fund a GRAT

- Key to success is the GRAT performance
- Asset selection differs from normal investment planning
- GRAT- prefer assets that carry a higher risk without conferring any additional expected return
  - May increase the return
  - May increase the probability of return

59

Continued

- Prefer assets with concentrations of assets
  - Use separate GRATS for separate assets
- Use Monte Carlo simulations
- Draft to hedge both the economic risk and the mortality risk

60

Risk as to Whether an Annuity Interest Constitutes a Qualified Interest

- Failure causes the complete transfer to be a taxable gift
- Three types of annuities may not be qualified
  - Zeroed out remainder
    - IRS may challenge the valuation
    - Won't issue private letter rulings if remainder interest is less the 10% or initial value of assets transferred
    - Questions certain value "formulas"

61

Annuity Interest for a Short Term

- Two year GRAT should be OK
- Kerr – 366 days
- Plural terms "amounts"
- Policy reasons questioning the term of the GRAT don't apply to zeroed out GRATs
- New IRS policy statements?
- Mid-term rates (3-9 years) dictates the term of the GRAT?

62

Improper GRAT Administration

- Similar to the CRAT rules
- Both draft and administrate accurately
- Payments made when dictated
- Can grantor enforce the payment rights
  - And fails to do so
- Can the grantor enforce proper administration
  - And fails to do so

63

Continued

- Collusion (real or implied) between grantor and trustee to delay or not make payments?
- Does this apply to a spousal GRAT?
- Legal rights under State law
- Extent of the grantor's legal rights
- IRS is auditing this issue
- Current survey

64

Solutions to Legal Uncertainties

- Require the trustee to adjust the size of the annuity or the length of the term of the GRAT to ensure the retained interest remains a qualified interest
  - Formula drafting
- GRAT automatically terminates s to any property required to be paid to the grantor on the latest of the date the payment must be made in order to constitute a qualified interest
  - Assets automatically vest in the grantor

65

Continued

- Trustee holds assets as a nominee or agent of grantor
- Grantor sends payment demand letters on a timely basis
- Require the trustee to pay with assets with the lowest cost basis
  - Benefits accrue to the remaindermen

66

Importance of the 105 Delayed Payment Rule

- Increase return accrues to the remaindermen
- Is this a taxable gift to the remaindemen
- State law consideration
- Improper GRAT administration
  - But – specific regulations
  - Trustee must make the payments within the 105 day period

67

GRAT PLANNING UPDATE

- Identify remainder beneficiaries in separate trust document
  - So grantor can engage in transactions with the remaindermen
  - Have different trustees – no merger of interests
  - Spouse as a potential/discretionary beneficiary of the remainder trust
  - Non-skip persons as beneficiaries to avoid a taxable termination
- Extending substitution powers beyond termination date
  - Allows grantor to substitute the assets he/she really wants to transfer to the remaindermen
  - Grantor trust "triggers" continue until all required annuity payments have been made

68

GRAT PLANNING UPDATE

- IRS auditing annuity payments
- Revocable GRATS
- Spendthrift clauses
- Deferred payment GRATS – required annuity beginning date

69

GRAT PLANNING UPDATE

- Spousal annuity – spouse with a short life expectancy
  - Contingent revocable interest to the spouse
  - Lower annuity payments in the earlier years
- Grantor with a short life expectancy – sell the remainder interest to the grantor trust
- Loans to grantor's spouse
- GST exemption allocation at the end of GRAT
- Does the GRAT/ETIP rule always apply?

70

GRAT PLANNING UPDATE

- Distributions/redemptions from entities transferred to GRATs – avoid sham transactions
  - Fund trust with liquid assets
  - Wait until after three years to make distributions/redemptions
- Blockage discounts in
  - No blockage discounts out
- Rolling GRATs with a single trust instrument

71

Estate Freeze Through Sales

- Installment Sales-effective estate freeze
  - Definition: taxable sale of property reported using the installment sale provisions of Sec. 453
    - One or more payments received other than in the year of sale
  - Advantages
    - Removes transferred assets from seller's estate
    - Converts assets into an income stream
    - Deferral of income taxes
    - Installment sale treatment
    - Flexibility in planning

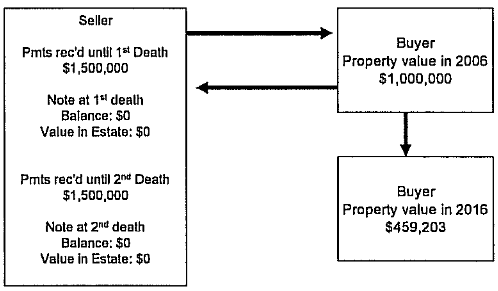
72

Estate Freeze Through Sales—Continued

- Income Tax Considerations
- Related Party Rules
- Important to Observe Tax Rules Carefully
- Disposition/transfer of Contract

73

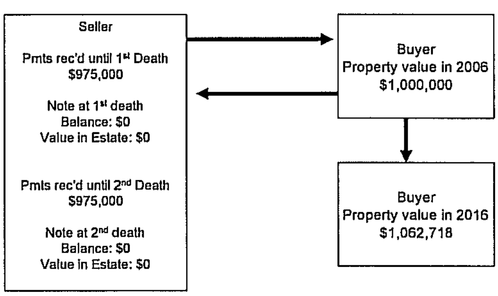
Installment Sale



Without discounts

74

Installment Sale



With 35% discount

75

Gift and Estate Tax Considerations

- Capping (freezing) Value
- Donor Appreciation
- Seller's Premature Death
  - Present Value of Installments
  - IRD – income in respect of decedent

76

Gift and Estate Tax Considerations—Continued

- Advantages
  - Spread Capital Gains
  - Remove Future Growth
  - Secure the Payments – if desired

77

Estate Tax Considerations—Continued

- Advantages—Continued
- Buyer Funding
- Basis Adjustments
- Life Interest
- AFR v. 7520 rate

78

Insurance Planning With Installment Notes

- Seller Considerations
- Buyer Considerations
- ILITs
- Gifting Premiums

79

Increasing the Planning Value of Installment Sales

- Sell rapidly appreciating assets
- Sell assets temporarily depressed in value
- Sell valuation discounted assets
- Note forgiveness
- Assets that may be used for an IPO at a later date
- Creative structuring of the note(s)

80

Income and Estate Tax Issues

- Income tax issues
  - Elect out of installment treatment in the year of sale
  - Sale to a grantor trust
    - No gain recognition
    - Basis step up
- Estate tax issues

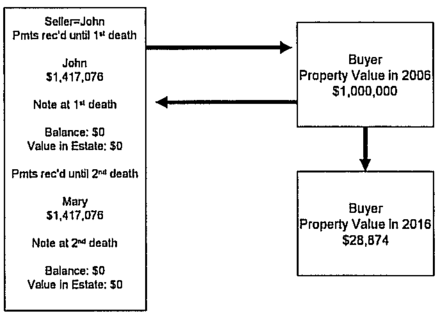
81

Self-Canceling Installment Note (SCIN) – Estate Freeze

- Cancels at Seller's Death
- Mortality Risk Premium
  - Interest or principal adjustment
  - Determine which maximizes benefits to the family
- No Estate Tax Inclusion
- Same Income Tax Issues
- Reduces the Seller's estate if Seller dies during the term of the note

82

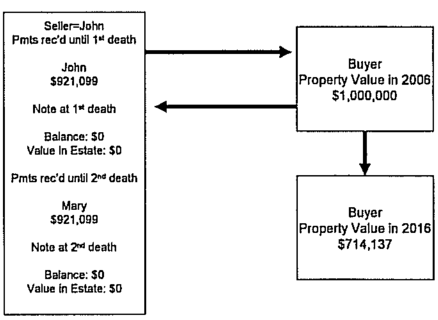
Self-Cancelling Installment Note



Without discounts

83

Self-Cancelling Installment Note



With 35% discount

84

Self-Canceling Installment Note (SCIN) – Estate Freeze - Continued

- Planning considerations
  - Interest and principal payments
  - Age
  - Life expectancies
  - Health
    - 18 months life expectancy
    - Presumption of good health
    - Obtain doctor's written opinion
  - Cash flow needs
  - Ability of transferred assets to generate payments

85

Creative Uses of SCINs

- Use SCINs to hedge planning risks
  - Mortality risk: using a SCIN sell assets in an amount that equals the value of other assets that may be included in the grantor's estate
- Potential Estate Tax Repeal
  - Do a series of SCINs to cover the risk of repeal or increasing exclusions amounts, and convert the SCINs to regular installment notes at the end of the SCIN terms.

86

Creative Uses of SCINs – cont.

- Use a SCIN where you have a serious health risk and a concern with a premature death.

87

IDGIT/SCIN/GRAT TECHNIQUE

- Because of the risk premium SCINs can transfer more wealth back to the seller than does a GRAT or a regular installment note.
- Solution:
  - Sell discounted FLP interests to an IDGIT using a series of SCINs

88

IDGIT/SCIN/GRAT TECHNIQUE – cont.

- Transfer the SCINs to a disregarded entity such as a single person LLC
- Transfer the disregarded LLC to a GRAT structured around the cash flow generated by the SCIN
- Variation: IDGIT or other grantor trust purchases assets from a GRAT in exchange for a SCIN or series of SCINs

89

SCIN Advantages

- Future appreciation of the assets in excess of the not interest rate and risk premium are removed from the
  Seller's estate
- Note cancels at death with no estate inclusion
- Exponential leverage if Seller dies before the note is paid off
- No gain or loss on the sale
- Increase value by using discounted assets

90

SCIN Mathematics

- Wealth transferred is the difference between the actual rate of return and the risk adjusted AFR
- Note cancels at death
- Discounted assets are sold
- Backload the installment payments

91

Intentionally Defective Grantor Income Trust - IDGIT

- Definition
  - Estate freeze
    - Significant upside potential
    - Ideal for high-income/high-growth assets
    - Effective for generation-skipping transfer planning
    - Great way to make unreportable, non-taxable gifts – annual exclusions
    - Most frequent use is to do a non-taxable sale
  - Non-statutory creature
  - Manageable legal risks

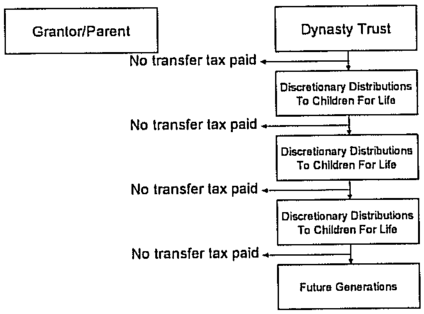
92

Dynasty Trust

- A trust designed to maintain wealth within a family unit over several generations
  - Or in perpetuity
    - State law considerations
    - Anti-alienation rules
- The trust assets are not subject to estate taxes at each subsequent generation
  - $2.0 million GSTT exemption
- Compounding of multi-generational wealth transfer tax free
- Asset protection
- Design flexibility

93

Dynasty Trust distribution upon grantor's death



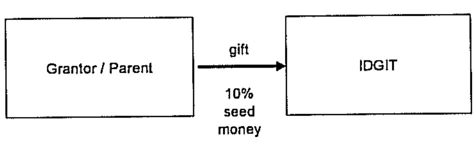
94

Advantages of a Dynasty Trust

- Maximum advantage of the GSTT exemption amount - $2.0 million
- Use the gift tax lifetime exemption - $1.0 million
- Trust assets appreciate and are transferred without additional transfer tax
- Grantor can pay income taxes on trust income
- Creditor and asset protection for generations
- Flexibility in drafting

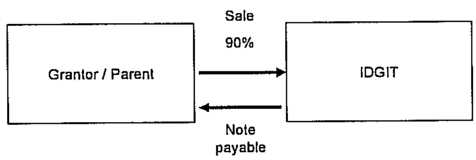
95

Sale to an IDGIT



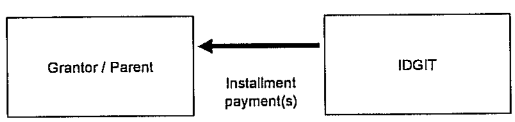
96

Sale to an IDGIT



97

Sale to an IDGIT



98

Tax Treatment of Sales to IDGITs

- Completed Transfer For Gift and Estate Tax Purposes
- Value of the Note In the Seller's Estate
- Other Issues

99

Intentionally Defective Trust – IDGIT - Continued

- Mechanics
  - Installment sale to an irrevocable trust in exchange for an interest-bearing note, SCIN or private annuity
  - Trust is treated differently for income and transfer tax purposes
  - Note is typically interest-only with a balloon principal payment at the end of the note term
  - Up-front gift of cash and/or property may be made prior to sale to reduce risk of IRS challenge
  - Many consider this more flexible than a GRAT

100

Intentionally Defective Trust – IDGIT - Continued

- Grantor Trust for Income Tax Purpose
  - Power to substitute assets
  - Borrow without security / adequate interest
  - "Toggle" switch
- Possible Tax Problems
  - Income taxes at death
  - IRC Sec. 2036 estate tax inclusion

101

Intentionally Defective Trust - IDGIT - Continued

- Sale to Trust
- Leverage
- Appropriate Interest Rate
- Seed Money—Gifts
  - 10% gift to trust – down payment
  - Personal guarantees

102

Intentionally Defective Trust – IDGIT -Continued

- Carefully Document the Sale
- No Capital Gain on sale to the trust
- No Tax on Income to the trust
  - Grantor pays the tax on the income
  - No additional gift to the trust
    - Rev. Rul. 2004-64
- Consider electing out of installment sale treatment in the year of sale.

103

Advantages of an IDGIT

- Freeze value of assets at the low interest rate on the installment note – AFR
- No capital gains tax on the sale
- Grantor trust for income tax purposes
  - Grantor pays income taxes
  - Additional tax free transfer of wealth
  - Toggle switches
- Sale of discounted assets increases leverage
- Other advantages are similar to the Dynasty Trust

104

IDGIT Mathematics

- Difference between the actual rate of return and the Sec. 7520 rate of return
- Valuation discounts on assets gifted/sold
- Sale does not trigger capital gains tax
- Grantor pays the income taxes on income earned by the trust
- Creative structuring of the notes
  - SCINs – cancellation at death
  - Backloading with balloon payments

105

Intentionally Defective Trust – IDGIT - Continued

- Trigger Clauses
- GSTT Issues
- Drafting the Trust

106

GRAT vs. Sale To IDGIT

GRAT:
- Tax treatment certain
- Zero-out taxable gift
- Annuity payments = value transferred
- 7520 hurdle rate
- Major mortality risk
- GST planning: no

Sale to IDGIT:
- Tax treatment uncertain
- Up-front taxable gifts
- Interest-only balloon note permissible
- Lower AFR hurdle rate
- Minor mortality risk (death with note outstanding may result in capital gains tax)
- GST planning: yes

107

IDGIT Planning Issues

- Determining the Client's Suitability
- Advantages of Installment Sales to IDGITs
- Disadvantages of IDGITs
- Increasing the Planning Value of Sales to IDGITs
- Combining the Sale to an IDGIT With Life Insurance

108

Structuring the Sale to an IDGIT

- Introduction
- Grantor Trust Issues – IRC Secs. 671-679
- Converting the Grantor Trust Status
- Avoiding IRC Sec. 2036 Estate Tax Inclusion
- Drafting the Installment Note
- Creative Drafting Techniques

109

IDGIT PLANNING UPDATE

- Required seed money
- Debt vs. equity issues
  - Equity causes estate tax inclusion
    - Sec. 2036
- Cash gifts
- Guarantees

110

IDGIT PLANNING UPDATE – cont.

- Chapter 14 issues – Secs. 2701 and 2702
- Valuations Risks
- Gift tax reporting
- Documentation!!

111

Creative IDGIT Planning Techniques

- Avoiding the Recharacterization of Debt to Equity – Sec. 2036 Issue
- Valuation Adjustment Clauses
  - Significance of McCord
  - Drafting the defined valuation clause
  - Using defined valuation clauses in sales transactions
  - Avoiding "implicit" understandings and other "monkey business"
  - Formula disclaimers

112

Creative IDGIT Planning Techniques – cont.

- Drafting the SCIN to maximize the tax benefits
  - The SCIN "tax burn"
- The double LLC strategy

113

Summary of Planning Strategies

- Leverage the tax and financial planning
  - Select the best assets to gift and transfer
  - Valuation discounts
  - Improve cash flow
  - Use self-cancelling installment notes – SCINs

114

Select the Best Assets to Transfer

- Flow-through entities
- Lots of cash flow
  - FLPs
  - FLLCs
  - S Corporations

115

Use Valuation Discounts

- Minority interest discount – less than a controlling interest
- Lack of marketability discount – difficult to transfer or sell
- Discounts reduce/leverage
  - Value of the assets gifted and/or sold
  - Reduce the principal and interest going back to the transferor/seller
  - Increase the amount of the tax free transfer

116

Use Valuation Discounts – cont.

- Structure the transaction so that discounted assets are transferred "in" and non-discounted assets are transferred "out"
  - Dividends
  - Interest
  - Royalties
  - Other income

117

Use of Valuation Discounts – cont.

- Discounted entities help create an effective "tax burn"
- Try not to return assets "in-kind" to the transferor/seller
  - Sec. 2036 issues
  - Lose the maximum effect of the tax and financial plan

118

Improving Cash Flow

- Peg installment notes to Seller's cash flow needs
- Use joint-life notes
- Use multiple- notes
  - Short term
  - Long term
  - Varied rates and payment structures
  - Balloon payments
  - Stagger the payment starting and ending dates

119

Improving Cash Flow – cont.

- Conversion features – SCIN to a regular note
- Grantor trust for income tax purposes
  - Rev. Rul. 2004-64

120

Use SCINs

- Small risk premium if the rates are low
- Cancels at death
- Creatively structure the terms and rates of the notes
- Multiple notes
- Structure the transaction to avoid Sec. 2036 issues
- Compare rates of return and risks to regular installment notes

121

CONVERTING A NON-GRANTOR TRUST TO A GRANTOR TRUST

- Distributions without an ascertainable standard, change trustees so that more than half are related or subordinate parties. Sec. 6749(c).
- Turn the trust into a foreign trust. Sec. 679.
- Actually borrow asses from the trust without giving adequate security. Sec. 675(3).
- Exercise of powers by a trust protector.

122

CONVERTING A GRANTOR TRUST INTO A NON-GRANTOR TRUST

- Disclaiming, renouncing releasing powers that trigger grantor trust status.
- Exercise or non-exercise powers that trigger grantor trust status
- Adding and deleting trustees

123

CONVERTING A GRANTOR TRUST TO A NON-GRANTOR TRUST

- Terminating foreign trust status
- Exercise of powers by a trust protector
- Be sure the document allows you to "toggle" on and off the grantor status in each calendar year

124

That's All Folks!!

Any Questions?

125