CREATIVE WEALTH PLANNING WITH GRANTOR TRUSTS, FAMILY LIMITED PARTNERSHIPS, AND FAMILY LIMITED LIABILITY COMPANIES

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I. AN OVERVIEW OF MODERN WEALTH TRANSFER AND ASSET

PROTECTION PLANNING[1]

A. Introduction

Modern strategies for sophisticated wealth transfer and asset protection planning incorporate a multitude of different techniques and, often, ingenious variations on these techniques. The best planning occurs when several components are blended together to create an efficient, comprehensive plan to accomplish wealth shifting and asset protection in perpetuity. Typically, the components of this planning include trusts, leveraged wealth shifting strategies, and the use of entities to obtain valuation discounts. Each of the individual components must be well designed and drafted using the most appropriate tax and asset protection strategies, combining trusts and entities, selecting the best applicable state law, and financial modeling of the plan with sufficient sophistication to ensure the client's financial independence and well-being over an extended life expectancy.[2] Skilled practitioners blend each of these components together to create an effective, flexible, and comprehensive structure that will optimize tax and asset protection planning opportunities designed to meet the specific needs of the client and the client's family in perpetuity.

Trusts such as GRATs, ILITs, and QPRTs have long been used to manage and control assets, as well as to facilitate creative income and wealth transfer tax planning.[3] Not only are trusts useful in the current management of assets, but clients often establish dynasty trusts to manage assets and maintain both the control and beneficial enjoyment of the assets throughout multiple generations.[4] In addition to managing the control and enjoyment of assets, clients may use trusts such as Intentionally Defective Grantor Trusts (IDGTs)

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2. *See* Robert S. Keebler, *The Mathematics of Gifting & Inter Vivos Sales*, 2004 AICPA Advanced Estate Planning Conference; Roy M. Adams, *Mathematics and Economics for Estate Planners*, 30TH ANNUAL NOTRE DAME TAX AND EST. PLAN. INST., ¶ 2 (2004); Robert S. Keebler, *Mathematics of Estate Planning*, 33RD ANNUAL NOTRE DAME TAX AND EST. PLAN. INST., ¶ 13 (2007); Steven R. Akers & Theodore Atlaas, *Income Tax Issues Arising From Post-Mortem Planning,* 33RD ANNUAL NOTRE DAME TAX AND EST. PLAN. INST. ¶ 34 (2007); and Robert S. Keebler, *Financial Engineering in Turbulent Markets,* 35TH ANNUAL NOTRE DAME TAX AND EST. PLAN. INST. ¶ 29 (2009).

3. *See* sources cited *supra* note 2.

4. Thomas F. Kennedy, *Dynasty Trusts*, http://www.houstonestateplanning.com/CM/publications/DYNASTY.pdf (last visited Apr. 15, 2010).

and Beneficiary Defective Inheritor's Trusts (BDITs), which are income tax defective either as to the grantor or to a beneficiary, making either the grantor or the beneficiary responsible for the income taxes due on income received by the trust.[5]

Various closely-held entities also are helpful in accomplishing wealth shifting. Often family limited partnerships (FLPs), family limited liability companies (FLLCs), and S-Corporations are used for leveraged wealth shifting. Whereas a trust may designate the management, control, and beneficial enjoyment of many different varieties of assets, FLPs, FLLCs, and S-Corporations used in combination with trusts can significantly enhance the control and asset protection for certain, specific assets.[6] In addition, these entities are useful in fractionalizing ownership interests in an asset in order to obtain appropriate discount valuations when gifts and sales are involved in the planning process.[7] Typically, an essential component of moving wealth outside of the transfer tax system is the ability to obtain appropriate valuation discounts: "[p]assing on more value than meets the taxable eye in the transfer."[8]

Two of the most popular wealth shifting techniques used to disgorge existing wealth are installment note sales to IDGTs and Grantor Retained Annuity Trusts (GRATs).[9] The proper use of installment note sales to an IDGT consists of selling discountable, non-controlling interests in entities such as FLPs, FLLCs, and S-Corporations to an income tax defective trust in exchange for an installment note that is generally an interest-only note with a balloon payment at the end of the term.[10] With a GRAT, the grantor transfers assets to a trust in exchange for an annuity substantially equal in value to the transferred property.[11]

With both the GRAT and the IDGT, it is prudent for the estate owner to gift or sell a discountable income-producing asset to the trust, and to avoid receiving back payments with assets "in-kind" which are not discountable, such as cash, in order to maximize the potential for significant wealth shifting.[12] The goal is to avoid "in-kind" payments from the trust to the grantor

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5. I.R.C. §§ 671-678 (2010).

6. *See* George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, The Brooking Inst., 26-27 (1979).

7. *Id*.

8. *Id*. at 13.

9. *See* www.mjslaw.com/download/guidebook/guide12g.pdf; Shearman & Sterling LLP, *Estate Planning: Gifts to Grantor Retained Annuity Trusts and Sales to Intentionally Defective Grantor Trusts*, http://www.shearman.com.

10. *See Estate Planning–The Process: The Complete Guidebook,* http//:www.mjslaw.com/download /guidebook/guide12g.pdf. (last visited Apr. 15, 2010); *see* Shearman & Sterling LLP, *Estate Planning: Gifts to Grantor Retained Annuity Trusts and Sales to Intentionally Defective Grantor Trusts*, http://www. shearman.com.

11. *See Estate Planning—The Process: The Complete Guidebook, supra* note 10.

12. *See id*.

when payments are subject to valuation discounts.[13] Transferring discounted assets into a trust and receiving discounted assets back out of the trust is inefficient because it will defeat the wealth transfer and asset protection originally built into the plan, and is costly to accomplish.[14] These issues will be discussed more thoroughly throughout this article.

B. The 2010 Wealth Transfer Tax Changes

1. Federal Law Changes

Because the provisions of the Economic Growth Tax Relief Reconciliation Act (EGTRRA or the Act) were repealed for one year as of January 1, 2010, there have been significant changes with respect to the wealth transfer tax laws, all of which can potentially affect the planning issues discussed in this article.[15] The major changes include:

(1) The estate and GST taxes are repealed for one year, 2010;
(2) The gift tax is not repealed; and
(3) For decedents dying after December 31, 2009, subject to certain exceptions, the basis of property acquired from a decedent is the lesser of the decedent's adjusted basis, or the fair market value of the property on the date of the decedent's death.[16]

Practitioners need to be keenly aware that as of the end of 2010, the sunset provisions eliminate *all* of the changes made by the Act.[17]

The sunset provision of the Act generally provides that all of the provisions of and amendments made by the Act shall *not apply* (1) to taxable, plan, or limitation years beginning after December 31, 2010; or (2) in the case of Title V, to estates of decedents dying, gifts made, or generation-skipping transfers after December 31, 2010 (the wealth transfer provisions).[18] This means that unless Congress reinstates the Act or otherwise enacts new wealth transfer tax legislation, as of January 1, 2011, the Internal Revenue Code (IRC) of 1986 and the Employee Retirement Security Act of 1974 shall be applied and administered to years, estates, gifts, and transfers described above as if the provisions and amendments of the Act *had never been enacted*.[19] Everything reverts back to pre-EGTRRA (pre-2001) law!

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13. *See id.*
14. *See id.*
15. *See* Economic Growth and Tax Reconciliation Act of 2001, Pub L. No. 107-16, 115 Stat 38 (2001).
16. *See id.*
17. *See id.*
18. *See id.*
19. *Id.*

The 2010 changes require a carryover basis for inherited assets, a scheme which is known as the modified carryover basis regime.[20] This means that there is no step-up in basis allowed as a result of death. However, in certain situations the basis in property can go down, such as when the fair market value of the property as of the date of death is less than the adjusted basis.[21] IRC section 1022 curtails the step-up in basis for capital assets acquired from a decedent with the following two exceptions: (1) the executor of the estate may make an election to allocate up to $1.3 million to increase the *basis* of assets passing to anyone; and (2) the executor may also allocate up to $3 million to increase the *basis* of assets passing to a surviving spouse outright or to certain marital trusts such as a Q-Tip trust.[22] These elections are made to increase basis; they do not increase the amount of assets that can be passed to the appropriate beneficiaries.[23] There are complex issues surrounding the interpretation of the phrase "property acquired from a decedent," although it seems to encompass revocable trusts, jointly held property, properly structured insurance proceeds, and community property.[24] However, there are many other important types of wealth planning transactions such as irrevocable trusts, retained grantor powers, and powers of appointment, which may not be able to obtain the special step-up in basis.[25] Because the complexities of the modified carryover basis regime are beyond the scope of this article, the reader is referred to the article cited in the footnote for an excellent discussion of the issues regarding carryover basis.[26]

The gift tax will continue in 2010; however, the top tax rate will be 35% rather than the 45% top rate of 2009.[27]

Look closely at the 2011 changes. The estate and GST taxes return with a $1 million exemption for estates and approximately a $1.5 million GST tax exemption.[28] Unlike the estate tax, the GST tax exemption is indexed for inflation.[29] The top estate and GST tax rates will be 55% with an additional 5% surtax on certain large estates.[30] The gift tax will return to the pre-2001 system with a $1 million exemption and a 55% top rate.[31] Remember, the

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20. I.R.C. § 1022 (2010).

21. *Id.*

22. *Id.*

23. *Id.*

24. *See id.*; I.R.C. § 1022(a)(1).

25. *See infra* Part IV.

26. *See* Jonathan G. Blattmachr, *Planning for Carryover Basis That Can Be/Should Be/Must Be Done Now*, Estate Planning, March 2002 at 99; Jonathan G. Blattmachr, Michael L. Graham & Teresa Bush, *What a Fine Mess: How WTP Has Been Revised to Cope With Drafting in 2010*, copyright 2010 (unpublished manuscript, on file with the authors) [hereinafter Blattmachr, et al., *What a Fine Mess*].

27. *See supra* note 15.

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.*

bottom line is that all of the changes made for 2010 disappear in 2011 as if they never happened; everything reverts back to pre-EGTRRA (pre-2001) law.

2. Planning Issues

All of these changes create enormous complexities with respect to 2010 gifts and bequests and traditional wealth planning techniques such as GST tax planning, defined value clauses, Q-TIPs, etc. The problems occur because most of the planning techniques used by wealth planners are defined in terms of tax concepts that no longer have any meaning in 2010. For example, with respect to generation-skipping transfer tax matters, the Code provides that IRC Chapter 13 (the GST tax provisions) "shall not apply to generation-skipping transfer[s] [taxes] after December 31, 2009."[32] However, unless there is new legislation the estate and GST taxes both return in 2011.[33] Therefore, planners need to consider what the GST tax ramifications are for 2010 as well as for 2011 and beyond. For 2010 there is no GST tax, and, therefore, the GST tax exemption is zero. As a result, in 2010 death is not a taxable event for GST tax purposes. However, in 2010 the gift tax applies and, therefore, a gift taxable event eventually could have GST tax consequences. If a traditional GST tax exempt trust is established in 2010 when there is no GST tax exemption, what are the tax consequences (if any) of an event occurring with respect to said trust in 2011 (and also in the following years) when both the estate and GST taxes have been reinstated back to pre-EGTRRA (pre-2001) law?

These issues are further complicated by the uncertainty of possible wealth transfer tax legislation in 2010.[34] If there is new wealth transfer tax legislation, will it be retroactive to January 1, 2010, or will it be effective as of the date that it is enacted into law? If the legislation is retroactive, will the legislation survive constitutional challenges? No one knows the answers to these questions for certain.

3. The 2010 "Greenbook" Provisions[35]

The Greenbook provisions, issued as part of President Obama's 2011 fiscal year budget, indicate that the government is also considering additional changes to the current law, which could significantly affect the planning issues discussed in this article.[36] First, the Greenbook provisions contain a proposal that will create an additional category of "disregarded restrictions" that can be ignored when "valuing interests in a family-controlled entity such as an FLP or

32. I.R.C. § 2601 (2010).
33. *See* Victor Santiago, *Basic Taxes You Need To Be Aware Of*, 2007 NAT'L BUS. INST. 28, 29.
34. *See id*.
35. Dep't of Treas., General Explanations of the Administrative Fiscal Year 2011, *Revenue Proposals (2010), available at* http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf.
36. *See infra* text accompanying notes 40-43.

an FLLC transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family."[37] In these types of transactions, the transferred interest will be "valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations."[38] This proposal could eliminate certain valuation discounts with respect to FLPs/FLLCs depending on how Congress drafts the particular structure and the type of assets transferred (e.g., cash and marketable securities or real estate, farms, and operating businesses). If this proposal becomes law, it will apply to transfers after the date of enactment of the new law or regulations.[39]

Also, the Greenbook provisions contain a proposal setting forth certain requirements:

> [D]own-side risk in the use of GRATs by imposing the requirement that a GRAT have a minimum term of ten years. The proposal would also include a requirement that the [GRAT's] remainder interest have a value greater than zero and would prohibit any decrease in the annuity during the GRAT term. Although a minimum term would not prevent "zeroing-out" the gift tax value of the remainder interest, it would increase the risk of the grantor's death during the GRAT term and the resulting loss of any anticipated transfer tax benefit. This proposal would apply to trusts created after the date of enactment.[40]

4. State Death Tax Considerations

Even if there is no federal estate and GST tax, practitioners must do appropriate planning to avoid unwanted death taxes in states that still have or may enact state wealth transfer taxes:

> Currently nineteen states and the District of Columbia impose their own estate and/or inheritance taxes. Eleven states and the District of Columbia have estate taxes only. Six states levy only an inheritance tax, with the tax rate depending on the relationship of the heir to the deceased. New Jersey and Maryland levy both estate and inheritance taxes, making a total of nineteen states that tax their residences' estates.[41]

Also, keep in mind that state death tax laws are always changing. Kansas, Illinois, North Carolina, and Oklahoma all had state estate taxes that lapsed on January 1, 2010. Delaware added a temporary estate tax effective from July 1, 2009, through July 1, 2013. The exemption levels also are in flux. Last year

37. Dept. of Treas., *supra* note 35, at 124.
38. *Id*.
39. *Id*. at 126.
40. *Id*.
41. Ashlea Ebeling, *Where Not To Die in 2010*, FORBES, *available at* http://www.forbes.com/2010/02/03/state-estate-tax-laws-personal–finance-2010-map_print.html (2010).

Vermont dropped its exemption amount from $3.5 million to $2 million making the change retroactive to January 1, 2009. Connecticut raised its exemption from $2 million to $3.5 million as of January 1, 2010. With most states facing huge budget gaps and many state legislatures just convening, expect more changes this year.[42]

5. Conclusion

Regardless of the issues raised above, most of the tools and techniques discussed in this article utilize lifetime gifts and sales of discountable FLP or FLLC interests to income tax defective, perpetual dynasty trusts. Generally, with proper planning, these tools and techniques may not be significantly affected by the wealth transfer tax issues discussed in this section. Also, with proper planning, an independent trustee or trust protector can have the authority to modify the trust documents discussed in this article in order to react to a wide variety of changed circumstances, including any new tax legislation.[43] Leveraged gifts and sales of FLP or FLLC interests (with or without discounts), income tax and asset protection planning with respect to trusts and FLP/FLLCs, situs planning, dynasty planning, and family wealth management planning will remain effective wealth transfer and asset protection strategies regardless of the 2010 and 2011 transfer tax issues.[44]

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42. *Id*. For an excellent discussion of each state's death taxes, *see* Skip Fox, *2010 State Death Tax Chart: Revised Feb. 22, 2010* (unpublished manuscript, on file with the author at McGuire Woods).

43. *See infra* Part II.

44. *See* the many excellent discussions of this topic at the *44th Heckling Institute On Estate Planning*, including the following presentations: Steven R. Akers, Ronald D. Aucutt & Carlyn S. McCaffery, *Charting New Paths for Estate Planners Through the Changing Landscape of Tax Laws and Regulations*; Dennis I. Belcher, Carol A. Harrington & Jeffery Pennell*, Recent Developments* 44 HECKLING INST. ON EST. PLAN. (forthcoming Sum. 2010). *See also* Martin M Schenkman, *2010 Estate Tax Repeal—Is It Real? What's the Deal?*, copyright 2010 (unpublished manuscript, on file with the author); Jonathan G. Blattmachr, *The Unthinkable Has Happened: No Estate Tax and Carryover Basis*, PROP. AND PROB., May/June 2007; Blattmachr, et al., *What a Fine Mess*, *supra* note 26.

II. Wealth Planning with Family Limited Partnerships and Family Limited Liability Companies

A. Introduction—General Considerations[45]

FLPs and FLLCs are two of the most popular advanced wealth planning and asset protection techniques available to practitioners.[46] When they are properly drafted, funded, and administered, FLP/FLLCs are extremely effective tools for asset protection planning, estate and income tax planning, and management of family owned wealth, including investments, businesses, and real estate. Despite vigorous, increased IRS attacks on FLPs and FLLCs, they remain an important component of advanced wealth transfer and asset protection planning.[47] Generally, IRS attacks on FLPs and FLLCs have been successful only against overly aggressive structures where the taxpayer did not respect the formation or proper administration of the entity, attempted to use inappropriate valuation discounts, or the structure otherwise resulted in "retained interests" under IRC Section 2036, therefore triggering estate tax inclusion. Despite recent IRS victories, practitioners and their clients can be confident that properly formed, funded, and operated FLPs and FLLCs that have legitimate and significant non-tax reasons for their formation, will be respected for both wealth transfer tax and asset protection purposes.

However, the purpose of this article is not to re-examine the use of valuation discounts with respect to FLPs and FLLCs and the issues regarding the IRS victories and defeats with respect to FLP/FLLC wealth planning.[48]

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45. Although an LLC may be treated as a partnership for income tax purposes, for estate planning purposes there may be differences between a partnership and an LLC, including differences with respect to the amount of valuation discounts that may apply to restricted interests based on of lack of marketability, etc. One factor in valuing appropriate discounts is a partner or member's right to liquidate their interests. In some jurisdictions, LLC members have rights to liquidate their interests that are superior to those of a limited partner. This would result in lower valuation discounts for partnership interests than for LLC interests when members transfer them for estate and gift tax purposes. Because only restrictions that are no more restrictive than the default provisions created by applicable state law are taken into account in valuing the LLC or partnership interests. The IRS will disregard all other restrictions for wealth transfer tax purposes.

46. *See* S. Stacy Eastland, *Family Limited Partnerships: Current Status and New Opportunities*, 2009 A.L.I.-A.B.A. CONTINUING LEGAL EDUC. 1017.

47. John W. Porter, Milford B. Hatcher & Lee C. Schwemer, *Family Limited Partnership Valuation and Audit Issues: Where Are We Now—and What do We Do?*, 44th HECKLING INST. ON EST. PLAN. (forthcoming Sum. 2010); Stephanie Loomis-Price, *We Could Tell You, But Then We Would Have To Kill You-Privileges, Planning, and Partnerships*, (2010) (unpublished manuscript, on file with the author). Loomis-Price states that IRS audits of FLP's/FLLCs has become particularly vicious as evidenced by a lengthy, extremely detailed, and very invasive request for documents and information which the IRS has served on clients as part of the audit process. *Id.*

48. The following are examples of IRS victories: Estate of Schauerhamer v. Comm'r, 73 T.C.M. (CCH) 2855 (1997); Estate of Reichardt v. Comm'r, 114 T.C. 144 (2000); Estate of Harper v. Comm'r, 83 T.C.M. (CCH) 1641 (2002); Estate of Thompson v. Comm'r, 84 T.C.M. 374 (2002), *aff'd.;* Estate of Strangi v. Comm'r, 85 T.C.M. (CCH) 1331 (2003); Kimbell v. U.S., 244 F. Supp. 2d 700 (N.D. Tex. 2003), *vacated,* 371 F.3d 257 (5th Cir. 2004); Abraham v. Comm'r, 87 T.C.M. (CCH) 975 (2004), *aff'd,* 408 F.3d 26 (1st Cir. 2005); Estate of Hillgren v. Comm'r, 87 T.C.M. 1008 (2004); Estate of Bigelow v. Comm'r, T.C.M. (RIA) 2005-065 (2005). There are cases in which IRS attempts to assert includability under I.R.C.

Rather, the purpose of this article is to look at new and creative uses of FLP/FLLCs in combination with income tax defective grantor trusts, creative planning techniques which will dramatically enhance the results of traditional wealth transfer planning, asset protection planning, income tax planning, and life insurance planning.

B. Drafting Valid Non-Tax Reasons for the FLP/FLLC

The specifics of drafting and forming an appropriate FLP/FLLC are beyond the scope of this article. Generally, for wealth transfer tax purposes if the FLP/FLLC is properly drafted, funded, administrated, and established for legitimate and significant non-tax reasons, the structure will be respected by the IRS, appropriate valuation discounts with respect to restricted interests will be accepted, and planners can accomplish significant family wealth transfer, asset management, creditor protection, and income tax objectives.[49] Valid non-tax purposes for establishing an FLP may include any of the following:

(1) "Creating, preserving, and increasing family wealth";
(2) "Providing a mechanism for continuity of management of family assets, including active involvement by younger family members";
(3) Providing exclusive, coordinated, and centralized management of all family assets;
(4) Allowing for the pooling of investments for increased organization and efficiency, and enhancing future investment opportunities;

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§ 2036(a)(1) and have been unsuccessful. *See* Kimbell v. U.S., 371 F.3d 257 (5th Cir. 2004); Estate of Bongard v. Commissioner, 124 T.C. 95 (2005); Estate of Schutt v. Comm'r, 89 T.C.M. (CCH) 1353 (2005); Estate of Mirowski v. Comm'r, 95 T.C.M. (CCH) 1277 (2008); Estate of Miller v. Comm'r, 97 T.C.M. (CCH) 1602 (2009); Estate of Black v Comm'r, 133 T.C. 15 (2009). The following are examples of IRS defeats: Estate of Strangi v. Commissioner, 115 T.C. 478 (2000); Gulig v. Comm'r, 293 F.3d 279 (5th Cir. 2002); Knight v. Comm'r, 115 T.C. 506 (2000); Estate of Jones v. Comm'r, 116 T.C. 121 (2001); Dailey v. Comm'r, 82 T.C.M. (CCH) 710 (2001); McCord v. Comm'r, 120 T.C. 358 (2003); Lappo v. Comm'r, 86 T.C.M. (CCH) 333 (2003); Peracchio v. Comm'r, 86 T.C.M. (CCH) 412 (2003); Estate of Kelley v. Comm'r, 90 T.C.M. (CCH) 369 (2005); Estate of Bongard v. Comm'r, 124 T.C. 95 (2005); Temple v. U.S., 423 F. Supp. 2d 605 (E.D. Tex. 2006); Kohler v. Comm'r, 92 T.C.M. (CCH) 48 (2006); Astleford v. Comm'r, 95 T.C.M. (CCH) 1497 (2008); Gross v. Comm'r, 96 T.C.M. (CCH) 187 (2008); Pierre v. Comm'r, 133 T.C. No. 2 (2009). This list was compiled by Attorney Michael D. Mulligan as part of the following article: Michael D. Mulligan, *15 Years of Sales to IDITs-Where are We Now?*, 35 ACTEC J.227 (2009).

49. For excellent discussions of FLP/FLLC drafting issues *see* DAVID T. LEWIS & ANDREA C. CHOMAKOS, *THE FAMILY LIMITED PARTNERSHIP DESKBOOK: FORMING AND FUNDING FLPS AND OTHER CLOSELY HELD BUSINESS ENTITIES*, (2d ed. 2007); Steve R. Akers, *Family Limited Partnerships: Planning, Drafting and Implementation* (2006) (unpublished manuscript, on file with the author at Bessemer Trust Company, NA); Louis A. Mezzullo, *FLPs and LLCS: Planning and Drafting Issues* (2009) (unpublished manuscript, on file with the author); Howard M. Zaritsky, *The Current State of Estate Planning with FLPs and LLCs* (2009) (unpublished manuscript, on file with the author); Louis A. Mezzullo, *Recent Cases Affecting Family Limited Partnerships and LLCs* (2009) (unpublished manuscript, on file with the author); and Thomas C. Baird, *Company Agreement of Opportunity Investments GP, LLC*, in ADVANCED DRAFTING: ESTATE PLANNING & PROBATE 2006, Texas Bar CLE (2006).

(5) Avoiding fractionalization of family assets and providing a simplified method of transferring ownership interests;
(6) Lowering administrative costs, and reducing investment management fees and expenses through centralized coordinated, and active management of family assets;
(7) "Protecting assets from the claims of creditors";
(8) "Keeping assets and wealth within the family by restricting nonfamily members' rights to acquire interests (including provisions for retaining interests in the event of divorce)"; and
(9) Facilitating post-mortem transfers.[50]

Because of the flexibility that can be drafted into FLPs and FLLCs, they can be particularly useful tools for family wealth management and accumulation, regardless of whether or not valuation discounts and wealth transfer tax savings are incorporated into the structure. This results from the management structure and asset protection features that can be incorporated into FLP/FLLC agreements.[51] Additionally, almost any type of asset can be transferred to, invested, and managed in the FLP/FLLC including, but not limited to, family owned businesses, investment real estate, cash, stocks, and other marketable securities.[52] However, personal assets, such as the client's personal residence, should not be transferred to the entity without significant risk of estate tax inclusion.[53] Also, the client must retain sufficient assets and income in their own name outside of the FLP/FLLC structure to maintain the client's personal living expenses.[54]

C. Selected Income Tax and Other Planning Issues

In addition to the FLP/FLLC issues discussed above, practitioners need to be aware that there are a multitude of other significant and complex problems when planning for and administering partnership and LLC interests. These complexities result from the numerous technical partnership/LLC income tax issues that may arise from the application of IRC sub-chapter K (income taxation of partners and partnerships), IRC sub-chapter J (income taxation of estates, trusts, beneficiaries, and decedents), and other technical Code provisions such as IRC Section 469 dealing with passive activity losses.[55] For

50. TOP FINANCIAL AND ESTATE PLANNING ISSUES FOR 2008, 4 (Sharon Brooks & George Jones eds., CCH 2008).

51. *See generally id.* at 1-6 (discussing the different roles within a FLP).

52. *See* William C. Hussey II, *Preserving Family Wealth: Family Limited Partnerships and LLCs are (Still) Valuable Estate Planning Tools*, http://www.whiteandwilliams.com/cm/Publications/Publications365.asp.

53. *See id.*

54. *See* TOP FINANCIAL AND ESTATE PLANNING ISSUES FOR 2008, *supra* note 50, at 27.

55. Robert G. Alexander, *Income Tax Issues with Respect to Partnership and LLC Interests Held in Trust* (Jan. 2009) (unpublished manuscript on file with the author).

example, sub-chapter K's partnership taxation rules provide important and creative opportunities for establishing the tax attributes of partnership and LLC interests held in trusts.[56]

Practitioners should also understand that partnership and LLC operating agreements can be two of the most significant estate planning documents required for planning with respect to retired or deceased partners/members. The significance of these documents may far exceed the relevance of more traditional estate planning documents such as inter-vivos or testamentary trusts. In addition, state law rights are established by the partnership or operating agreement; and, therefore, these agreements also determine most of the income tax consequences and relationships involving a partner or member terminating that partner/member's interest upon death or retirement, as well as the tax consequences and relationships of the remaining partners or members.[57] It is also possible that the partnership or operating agreement will be one of the most significant dispositive instruments. This is because the successors to the interests of a withdrawing, retired, or deceased partner or member can be determined by the partnership or operating agreement or by a separate "Buy-Sell" agreement.[58]

Finally, the controlling agreement and its tax consequences can be based on modifications prior to the date of filing of a proper tax return for the tax year in which the specific triggering event occurs, not including extensions.[59] This can provide significant opportunities for creative post-year-end tax planning, including anticipating a multitude of changed circumstances.[60]

III. WEALTH TRANSFER AND ASSET PROTECTION PLANNING WITH NEVADA RESTRICTED ENTITIES[61]

A. The New Nevada Restricted LLC and Restricted LP

As stated in Part I, sophisticated wealth planners often use FLPs and FLLCs to facilitate leveraged wealth shifting strategies utilizing gifts and installment sales of minority interests, non-voting interests to family members,

56. *Id.*
57. *Id.* at 2.
58. *Id.*
59. *Id.*
60. *See* Carol A. Cantrell, *Special Problems with Partnership Interests in Estate and Trust Administration*, AICPA Conference on Tax Strategies for the High-Income Individual, § 19 (2008); Richard B. Robinson, *Exiting the Discount Entity: What Happens When Family Members Want to Take Their Share and Run: Minimizing the Income Tax Costs*, 30th Annual Notre Dame Tax and Est. Plan. Inst., ¶ 10 (2004); Alan H. Baseman, et al., *Holding Partnerships & LLCS in Trust-the Rest of the Story: How to Determine Distributions of Income, Principal and Tax Attributes*, (Feb. 2009) (unpublished manuscript, on file with the authors).
61. Steven J. Oshins & Robert S. Keebler, *New Nevada Restricted LLP and LP Law: An Ideal Combination with a Graduated GRAT,* Estate Planning Vol. 37, No. 1, at 28, *available at* 37 EST. PLN. 28, 2010 WL 7815.

or irrevocable trusts created for the benefit of family members.[62] In addition to providing for non-voting interests, the entity partnership agreement or operating agreement usually will include specific provisions regarding management rights, fiduciary obligations of managing members, restrictions on liquidation rights, the transferability of entity interests, and admission of new members or partners.[63] Often these provisions are specifically drafted in order to obtain appropriate valuation discounts when gifting or selling entity interests.[64] Restrictions on liquidation rights, transferability of entity interests, and admission of new members significantly affect both the value of entity interests and the resulting wealth transfer tax issues.[65]

However, when "applicable restrictions" (restrictions which usually are specifically included in the partnership or LLC agreement in order to enhance wealth transfer and asset protection planning) are not properly drafted with reference to (1) specific state law, (2) the Internal Revenue Code, (3) Treasury Regulations, and (4) applicable rulings and case law, the applicable restrictions can be disregarded when valuing entity interests for wealth transfer tax purposes.[66] "Under IRC Section 2704(b) and Reg[ulation] 25.2704-2(a), if an interest in an entity is transferred to or for the benefit of a member of the transferor's family," any applicable restrictions are disregarded for federal wealth transfer tax purposes when valuing the transferred interest.[67] Treasury Regulation Section 25.2704-2(b) defines an applicable restriction as a "limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the state law generally applicable to the entity in the absence of the restriction."[68] These state law provisions generally are referred to as the state law default provisions.[69]

Until recently most state laws set forth statutory default liquidation restrictions that are limited to some form of the Uniform Laws regarding LPs and LLCs. However, a number of states, including Nevada, have enacted favorable state law default restrictions that can allow for slightly higher valuation discounts than the discounts obtained using the laws of most other states.[70] Remember, this can be very important in the wealth transfer and asset

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62. *See supra* note 7.

63. *See* NEV. REV. STAT. §§ 86.291, 86.286, 86.351, 86.362(2) (2010), *available at* http://www.leg.state.nv.us/NRS?NRS-086html.

64. *See* Appraisal Economics Inc., *Valuation Discounts & Family Limited Partnerships*, Mar. 22, 2010, http://www.appraisaleconomics.com/family.html.

65. *See id*.

66. I.R.C. § 2704(a)-(b) (2010).

67. Oshins & Keebler, *supra* note 61, at 28; I.R.C. § 2704(a)-(b) (2010); Treas. Reg. § 25.2704.2(b) (2010).

68. Treas. Reg. § 25.2704.2(b) (2010).

69. *See, e.g.*, Southex Exhibitions, Inc. v. Rhode Island Builders Ass'n., Inc., 279 F.3d 94, 99 (1st Cir. 2002).

70. *See* NEV. REV. STAT. § 86.343(3)(b), *available at* http://www.leg.state.nv.us/NRS/NRS-086.html#NRS086Sec343.

protection planning process because, over time, higher valuation discounts can increase significantly the amount of the wealth shift.[71]

On May 29, 2009, Nevada Senate Bill 350 was enacted which allows for the creation of a Nevada Restricted LLC or a Nevada Restricted LP.[72] This law had an effective date of October 1, 2009.[73] The difference between Nevada restricted LLCs and restricted LPs as opposed to standard LLCs and LPs is that the Nevada Restricted LLC and LP statutes have default provisions that restrict the entity from distributing its underlying assets for a ten-year period.[74] The new Nevada restrictions are the default statutory restrictions and therefore are not disregarded applicable restrictions pursuant to IRC Section 2704(b) and Treasury Regulations Section 25.2704-2(a) and (b).[75] These restrictions create the possibility of a significantly higher ceiling on valuation discounts than the discounts traditionally available under statutes modeled after the Uniform Laws, a ceiling not currently available in any state other than Nevada.[76] Therefore, these restrictions can significantly enhance the value of traditional leveraged wealth shifting techniques utilizing discountable FLP/FLLCs in combination with GRATs and installment note sales to IDGTs and BDITs.

The statutory provisions creating the new Nevada Restricted LLC laws can be summarized as follows:

A restricted limited-liability company is "a limited-liability company organized and existing under [NRS Chapter 86] that elects to include the optional provisions permitted by NRS 86.161."[77]

> 1. If a limited-liability company has elected in its articles of organization to be a restricted limited-liability company pursuant to NRS 86.161, subject to the provisions of NRS 86.343, and *unless otherwise provided in the articles of organization*, the company shall not make any distributions to its members with respect to their member's interests until 10 years after:
>
> (a) The date of formation of the restricted limited-liability company as long as the original articles of organization elect to be treated as a restricted limited-liability company and as long as the company has remained a restricted limited-liability company since the date of formation; or

71. Richard A. Oshins, *Advanced Planning Strategies Using Grantor Trusts,* 60 N.Y.U. TAX INST. ON FED TAX'N ¶ 27 (2001); Carlyn S. McCaffrey, Richard A. Oshins, & Noel C. Ice, *Planning with GRATs,* 62 N.Y.U. TAX INST. ON FED TAX'N (2004).

72. Linda B. Hirschson & Daniel L. Kesten, *Family Limited Partnership and Limited Liability Companies—Watching the Law Develop*, 352 PLI/EST 309, 316.

73. *Id*.

74. NEV. REV. STAT. § 46.345 (2010), *available at* http://leg.state.nv.us/NRS/NRS-086.html.

75. Law Offices of Oshins & Associates, LLC, *Nevada Restricted LLC and LP*, Mar. 22, 2010, http://www.oshins.com.

76. Hirschson, *supra* note 72, at 317.

77. NEV. REV. STAT. § 86.1252 (2010), *available at* http://www.leg.state.nv.us/NRS/NRS-086.html#NRS086Sec1252.

> (b) The effective date of the amendment to the articles of organization in which the company elected to be treated as a restricted limited-liability company and as long as the company has remained a restricted limited-liability company since the effective date of the amendment.
>
> 2. The provisions of this section apply as the default provisions of a restricted limited-liability company to the extent the provisions of this section are inconsistent with or add to the other provisions of [NRS Chapter 86] and to the extent not otherwise modified in the articles of organization of the restricted limited-liability company.[78]

The new statutes regarding the Nevada Restricted Limited Partnership Laws are set forth in NRS 87(a) and 88.[79] These provisions are almost identical to the provisions of the new restricted LLC laws set forth above.[80]

For planning purposes, advisors need to understand that the new statutory provisions do not require that the underlying assets be locked into the LLC or LP for the entire ten years.[81] Both statutes allow planners a great deal of flexibility in order to structure the LLC or LP to unlock the underlying assets and provide for distributions after a period of less than ten years. Therefore, planners can be very creative in structuring how, when, and for what purposes distributions can be made.

After passage of the new acts, attorney Steven J. Oshins (who drafted the new Nevada restrictions and worked with both the Nevada State Bar and the Nevada legislature to enact these restrictions) contacted several highly recognized business valuation firms and requested them to estimate the amount of additional valuation discounts, if any, that could be available using one of the new Nevada Restricted Entities.[82] Attorney Oshins summarized these opinions in examples one through five below.[83] Two important factors stand out with respect to the conclusions in each example. First, each opinion estimates that the Restricted Entity will allow additional valuation discounts over and above the discounts which are traditionally available under the Uniform Laws.[84] Second, the amount of the additional discounts may vary depending on the specific restrictions incorporated into the Restricted Entity agreement.[85] Therefore, the new Nevada Restricted LLC and LP statutes seem to allow for a great deal of creativity in structuring the entity while, at the same time, creating a new ceiling on applicable valuation discounts. As illustrated

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78. NEV. REV. STAT. § 86.345 (2010) (emphasis added) *available at* http://leg.state.nv.us/ NRS/NRS-086.html.

79. *See* NEV. REV. STAT. §§ 87a, 88 (2010), *available at* http://leg.state.nv.us/NRS/NRS-086.html.

80. *See infra* Exh. A.

81. *See* NEV. REV. STAT. § 86.345(1) (2010), *available at* http://leg.state.nv.us/NRS/NRS-086.html.

82. Steven J. Oshins, *Flash – Nevada Restricted LLC and LP Laws Enacted*, Steve Leimberg's Est. Plan. Newsletter # 1471, May 30, 2009.

83. *Id*.

84. *See id*.

85. *See id*.

by each of the five examples, in order to meet the specific needs of the estate planning client, drafting attorneys can structure the specific provisions of the restricted entity to allow for distributions either in a specified amount after a specified period of time or according to discretionary authority specified in the partnership or operating agreement.[86] For example, the underlying assets could be locked in for a ten-year period, a five-year period, or perhaps a three-year period. The agreement could also provide for the discretionary right to make distributions up to a stated percentage per year; this could be very important in the event it is necessary or advisable to make distributions in order to allow the partners or members to meet their individual income tax liabilities with respect to FLP or FLLC income (phantom income) which is not distributed in any particular year.

Example 1: No Distributions for Ten Years

> [T]he Restricted Entity disallows any member/partner distributions for ten years. Appraiser #1 estimated an additional 10% to 30% discount on top of the discount that would be obtained without this additional provision. Appraiser #2 estimated an additional 15% to 35% discount on top of the discount that would be obtained without this additional provision.[87]

Example 2: No Distributions for Five Years

> [T]he Restricted Entity disallows any member/partner distributions for five years. Appraiser #1 estimated an additional 5% to 20%+ discount on top of the discount that would be obtained without this additional provision. Appraiser #2 estimated an additional 10% to 25% discount on top of the discount that would be obtained without this additional provision.[88]

Example 3: No Distributions for One Year

> [T]he Restricted Entity disallows any member/partner distributions for one year. Appraiser #1 estimated an additional 3% to 10% discount on top of the discount that would be obtained without this additional provision. Appraiser #2 estimated an additional 3% to 10% discount on top of the discount that would be obtained without this additional provision.[89]

Example 4: Restrictions on Distributions With Exceptions for Income and Growth

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86. *See id*.
87. Oshins & Keebler, *supra* note 61, at 30.
88. *Id*.
89. *Id*.

> [T]he Restricted Entity disallows any member/partner distributions ranging from one to ten years, except to allow all income/growth beyond the capital contributions to be distributed. Appraiser #1 estimated additional valuation discounts on top of the discount that could be obtained without this additional provision, ranging from 3% for a one-year restriction up to 10% for a ten-year restriction. Appraiser #2 estimated additional valuation discounts on top of the discount that could be obtained without this additional provision, ranging from 2% for a one-year restriction up to 15% for a ten-year restriction.[90]

Example 5: Restrictions on Distributions Except for Amounts to Pay Federal/State Income Tax

> [T]he Restricted Entity disallows any member/partner distributions ranging from one to ten years, except to allow for distributions in an amount equal to the highest federal/state income tax payable by individual members/partners attributable to income retained by the LLC/Partnership. Appraiser #1 estimated additional valuation discounts on top of the discount that would be obtained without this additional provision, ranging from 2% for a one-year restriction up to 10% for a ten-year restriction. Appraiser #2 estimated additional valuation discounts on top of the discount that could be obtained without this additional provision, ranging from 3% for a one-year restriction to 15% for a ten-year restriction.[91]

Obviously, the planning possibilities with Nevada Restricted Entities are endless. Creative wealth planners can design the Restricted LLC or LP to meet the specific needs of the client. For example, Attorney Oshins suggests that if non-voting interests "in a Restricted LLC [are] being gifted to a ten-year GRAT, the draftsman might put the ceiling on distributions in an amount just high enough to make the annuity payments each year with all restrictions to be removed at the end of the ten-year period."[92]

B. Planning with Nevada Restricted Entities and GRATs

Attorney Steven J. Oshins and CPA Robert S. Keebler, discuss new and innovative GRAT planning strategies in their article titled the *New Nevada Restricted LLC and LP Law: An Ideal Combination with a Graduated GRAT*.[93] A discussion of GRATs is beyond the scope of this article; however, practitioners need to understand that in order for a GRAT to successfully transfer wealth, the growth of the GRAT assets during the term of the GRAT

90. *Id*. at 30-31.
91. *Id*. at 31.
92. *Id.*
93. *See id*.

must be greater than the applicable IRC Section 7520 rate, otherwise the strategy will generally fail.[94] Therefore, in order to allow greater transfer tax leverage and design a GRAT to successfully transfer wealth, the authors suggest that the GRAT can be designed so that the annuity payments are "back loaded."[95] This technique of back loading is known as a "graduated GRAT"; the GRAT annuity payments increase over time allowing the GRAT assets to grow in value in an amount greater than if GRAT payments are "front-end loaded," meaning the payments remain constant over the term of the GRAT.[96] With back loading, the annuity payment cannot increase from one year to the next by more than 20% of the previous year's payment.[97]

Advanced wealth planners often "leverage" the mathematics of the GRAT and the ultimate amount of the wealth transfer by gifting assets to the GRAT, which are structured to allow for valuation discounts.[98] The valuation discounts mean that the required GRAT annuity payments can be lower than for GRATs funded with assets to which discounts do not apply.[99] Interestingly, the larger the valuation discount applicable to the assets transferred to the GRAT, the shorter the term of the GRAT needs to be to successfully transfer wealth.[100] Also, with a shorter GRAT term, the mortality risk (and, therefore, possible estate tax inclusion) of the GRAT can be mitigated.[101]

Oshins and Keebler suggest two different planning options that a practitioner can use to combine a Nevada Restricted Entity and a graduated GRAT.[102] Both options will significantly enhance the GRAT's leveraged wealth transfer because of the greater valuation discounts available to Nevada Restricted LLCs and LPs:

> One option is to design the Restricted Entity to allow a distribution, in the first fiscal year, of a relatively small percentage of the fair market value of the assets initially contributed to the Restricted Entity, followed each successive year by a slightly larger allowable amount that can be distributed. All other assets contributed to the Restricted Entity would be restricted from being distributed to the owners, thereby allowing for a greater valuation discount than would occur with a traditional business entity . . . .
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> . . . .

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94. *See generally* I.R.C. § 7520 (2010) (explaining valuation tables for the value of annuities, any interest for life or term of years, or any remainder or reversionary interest).

95. *See* Oshins & Keebler, *supra* note 61, at 31.

96. *Id.*; *see also* Steve R. Ackers, *Advanced Transfer Planning Including Strategies to Maximize Benefits of GRATs and Sales to Grantor Trusts Given Recent Market Declines*, A.L.I. 801, 819 (2009).

97. Oshins & Keebler, *supra* note 61, at 31.

98. *See id.*

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.*

The second option is to draft the Restricted Entity to take full advantage of the ten-year restriction that the new Nevada law allows and to supplement the gift of the Restricted Entity interest with cash or cash-like assets in an amount equal to the anticipated annuity payments. Whether this approach will be better or worse than the first option will depend on various factors, including the appropriate valuation discount determination of the business valuation appraiser.[103]

C. Nevada Restricted Entities and the SCIN-GRAT Technique

An interesting planning opportunity with discounted FLPs or FLLCs that can be enhanced by the larger valuation discounts available through the use of a Nevada Restricted Entity is the SCIN-GRAT technique described by attorneys Steven J. Oshins and Kristen E. Simmons in their article titled *The SCIN-GRAT: A Hedging Technique Takes the Mortality Risk Out of Estate Planning*.[104] The SCIN-GRAT is "a hedging technique that combines a bet-to-die strategy [a self-cancelling installment note ("SCIN")] with a bet-to-live strategy [a Grantor Retained Annuity Trust (GRAT)]."[105] In a traditional note sale to an IDGT, the client sells discounted, non-controlling FLP/FLLC interests to an IDGT in exchange for an interest-only promissory note bearing interest at the applicable federal rate (AFR), with a balloon payment due at the end of a term of years.[106] Throughout this article, keep in mind the critical importance of the sophisticated financial modeling necessary for a successful, leveraged wealth shift with GRATs, IDGTs, and BDITs. The most significant wealth shift occurs when discounted FLP/FLLC interests are gifted and sold utilizing these leveraged wealth shifting strategies. Nevada Restricted Entities can provide larger valuation discounts and therefore increase the probability of a successful wealth shift.[107]

The specific planning technique which is incorporated into the SCIN-GRAT technique is that the promissory note is structured as a SCIN rather than as a traditional installment note.[108] Although the specifics of structuring a SCIN transaction are beyond the scope of this article, practitioners should note that there is a risk of over-paying for the SCIN if it is not properly structured.[109] To hedge against this risk, the SCIN-GRAT technique combines the initial

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103. *Id.* at 31-32.

104. Steven J. Oshins & Kristen E. Simmons, *The SCIN-GRAT: A Hedging Technique Takes the Mortality Risk Out of Estate Planning,* TRUSTS & ESTATES, June 2008, at 18, *available at* http://www.oshins. gm/images/SCIN_GRAT_Steve_and_Kristen.pdf.

105. *Id.*

106. *Id.*

107. *See* Oshins & Keebler, *supra* note 61, at 31.

108. *Id.*

109. *See* Robert S. Keebler, Presentation at AICPA ADVANCED EST. PLAN. CONF.: *The Mathematics of Gifting and Inter Vivos Sales* (May 20 2004); *see* Robert S. Keebler, *Mathematics of Estate Planning,* Presentation at 33RD ANNUAL NOTRE DAME TAX & EST. PLAN. INST. (Oct. 12, 2007).

component of the transaction, a sale to an income tax defective trust using a SCIN, with a GRAT.[110] The authors state that this combination of a debt-to-die strategy and a debt-to-live strategy ensures a successful leveraged wealth transfer.[111]

Once the sale is completed, the owner of the SCIN establishes a single member LLC that is taxed as a "disregarded entity" for income tax purposes. The SCIN, along with other assets, is transferred to the LLC.[112] Transferring the SCIN and other assets to the LLC does not trigger a taxable event because the LLC is a disregarded entity for income tax purposes.[113] Generally, the LLC is structured with a 1% voting interest and 99% non-voting interests.[114] The owner of the LLC will transfer the non-voting interests.[115] The next step in this transaction is to have the LLC owner establish one or more "zeroed-out" GRATs for the benefit of the owner, their spouse, children, or both.[116] Subsequently, the LLC owner transfers by gift, a portion of the owner's non-voting, minority LLC interests to the GRAT in exchange for an annuity of substantially equal value. An appropriate valuation discount as determined by an independent appraisal is applied to the gift of the non-voting, minority LLC interests.[117] Because the GRAT is structured as a grantor trust for income tax purposes, the LLC continues to be taxed as a disregarded entity even after the transfer of the non-voting LLC interests to the GRAT.[118]

With the SCIN-GRAT strategy, the GRAT is used to hedge against the event that the grantor outlives the term of the SCIN.[119] In the event the grantor dies prior to the expiration of the GRAT term, the grantor will not have outlived the SCIN term and, therefore, the remaining SCIN payments will be cancelled. Because the main assets of the GRAT are non-voting membership interests in an LLC whose primary asset consists of the SCIN obligation, then if the grantor dies during the term of the GRAT, there will be almost no value remaining in the GRAT for inclusion in the grantor's estate. Therefore, the survivorship requirement inherent in a traditional GRAT (the mortality risk) is mitigated, at least as to the portion of the GRAT assets involved with the SCIN-GRAT strategy. If the grantor survives the GRAT term, the leveraged wealth shift inherent in the GRAT is successful, and the GRAT assets are transferred to the remaindermen without additional transfer tax. Typically, the remainderman is an income tax defective dynasty trust.

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110. *See* Oshins & Keebler, *supra* note 61, at 18.

111. *See* Simmons, *supra* note 104, at 19-20.

112. *Id*. at 20. A disregarded entity is a single-owner LLC that has not elected to be classified as an association (corporation). I.R.C § 7701 (2010).

113. *See* Simmons, *supra* note 104, at 19-20.

114. *Id*.

115. *Id*.

116. *Id*.

117. *See id*. at 21.

118. *See infra* Exh. B.

119. *See* Simmons, *supra* note 104, at 20-21.

As a final planning point, the grantor of the GRAT, who also is the owner of the LLC, should establish a GRAT term that is as short as possible and based on an analysis of the amount and term of the SCIN payments attributable to the portion of the LLC transferred to the GRAT. This is easy to determine because the SCIN payments already will have been negotiated and set prior to establishing the GRAT.[120] Because the value of the non-voting, minority LLC interests gifted to the GRAT will be subject to valuation discounts, the GRAT's term generally should be much shorter than the SCIN's term.[121] Obviously, the additional valuation discounts which can be available by using a Nevada Restricted Entity will enhance the wealth shift inherent in this strategy.[122]

Generally, the planning benefits of a SCIN-GRAT technique depend on when the Grantor dies.[123] However, regardless of when this event occurs, with proper planning there can be a significant wealth shift and estate tax savings using the SCIN-GRAT technique.

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120. *Id*. at 22.
121. *See id*.
122. *Id*.
123. *Id*. at 25-26.

IV. WEALTH PLANNING WITH ASSET PROTECTION TRUSTS AND FLPS AND FLLCS

A. *Introduction to Asset Protection Trusts*[124]

A Domestic Self-Settled Asset Protection Trust (DSAPT) is an irrevocable trust established under special laws adopted in a handful of states such as: Alaska, Delaware, Nevada, and South Dakota.[125] These special laws permit a settlor to establish a trust for the settlor's own benefit which will enable the settlor to obtain significant wealth transfer and asset protection planning benefits for the settlor which are completely unavailable (and often statutorily prohibited) for self-settled trusts in other states.[126] Under these statutes, if the trust is properly structured and administered, it generally can protect the settlor's assets from the settlor's creditors once the DSAPT has been established and funded for the specific number of years which allow transfers to the trust to escape the specific state's statute of limitations for transfers in fraud of creditors.[127] These statutes of limitations generally range

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124. There are many excellent discussions of the complex issues regarding asset protection and asset protection trusts. *See* Osborne, Duncan E. et al., *Asset Protection: Domestic and International Law Tactics,* (Eagan: West Thomson Reuters, 2010); Lewis D. Solomon & Lewis J. Saret, *Asset Protection Strategies,* (2009 ed.) Chicago: CCH, 2008; Spero, Peter, *Asset Protection: Legal Planning Strategies*, Warren, Gorham & Lamont/RIA, 2001; Engel, Barry S., et al., *Asset Protection Planning Guide: A State-of-the-Art Approach to Integrated Estate Planning*, Chicago: CCH, 2000; Charles D. Fox, IV, *Choice of Law Can Be Difficult*: *Asset Protection/Perpetuity-Free, on/Perpetuity-Free Self-Settled Discretionary Dynastic Trusts*: *Rapid Changes in State Laws, State Laws Comparison Noting Those Which are "Favorable" or "Unfavorable" to Particular Techniques: Factors to Consider in Choosing Appropriate Jurisdiction,* 26th Annual Notre Dame Tax and Est. Plan. Inst. ¶ 2 (2010); Santo Bisignano, Jr., *Asset Protection Without a Passport: Steps to Take to Secure the Asset Protection Benefits Inherent in Both Traditional and Cutting-Edge Estate Planning Techniques Including Use of Domestic Asset Protection Trusts,* 28th Annual Notre Dame Tax and Est. Plan. Inst. ¶ 31 (2002); Stephen R. Akers, *Selection of Trustees: Gift, Estate and Income Tax Consequences of Powers as Trustee Held by Grantors and Beneficiaries, Trustee Selection and Creditor Rights Issues*, 30th Annual Notre Dame Tax and Est. Plan. Inst. ¶ 13 (2004); Alvin J. Golden, Santo Bisignano, Jr. & Toby M Eisenberg, *Bankruptcy Act Impact on Estate Planning, Traditional Asset Protection Planning, FLPs Self-Settled Trusts, Life Insurance, GRATs, Homestead. "I Thought It Was Only About Credit Cards,"* 31st Annual Notre Dame Tax and Est. Plan. Inst. ¶ 33 (2005); Richard W Nenno, *Planning and Defending Domestic Asset-Protection Trusts,* 32nd Annual Notre Dame Tax and Est. Plan. Inst. ¶ 11 (2006); Mark Merric, *Asset Protection Entities of Choice: Sole Remedy Charging Order with FLPs and LLCs' Nevada's New Charging Order Statute for Corporate Stock; Inherited Wealth and Discretionary Dynasty Trusts; from the 10 DAPT States, Who Are the Leading Domestic APT States? Offshore APT*, 33rd Annual Notre Dame Tax and Est. Plan. Inst. ¶ 29 (2007); Charles D Fox, IV, *Asset Protection Planning: Fundamentals and Current Developments*, 34th Annual Notre Dame Tax and Est. Plan. Inst. ¶ 34 (2008); John A Terrill, *Fraudulent Transfers,* 34th Annual Notre Dame Tax and Est. Plan. Inst. ¶ 35 (2008); Jeffery A. Schoenblum, *Looking for Law in all the Right (and Wrong) Places, Forum Shopping Opportunities, Unintended Consequences, and the Duties of the Estate Planner,* 44th Heckerling Institute on Estate Planning, January 2010, Gideon Rothschild, *Keeping it All in the Family: Asset Protection Planning,* 44th Heckerling Institute on Estate Planning, Jan. 2010.

125. ALASKA STAT. § 34.40.110(e) (2007); DEL. CODE ANN. Tit. 12, § 3572(d)-(e) (2007); NEV. REV. STAT. §§ 166.010-170, 1999 NEV. STAT. 299; S.D. CODIFIED LAWS §§ 55-16-12 to 13 (2009).

126. *See* ALASKA STAT. § 34.40.110(e) (2007); DEL. CODE ANN. Tit. 12, § 3572(d)-(e) (2007); NEV. REV. STAT. §§ 166.010-170, 1999 NEV. STAT. 299; S.D. CODIFIED LAWS §§ 55-16-12 to 13 (2009).

127. *See* 1984 Unif. Fraudulent Transfer Act § 1, 7A U.C.A. 275 (1984).

from two years (Nevada) to four years (Alaska and Delaware).[128] Generally, the laws of each state that authorize DSAPTs set forth specific requirements to establish and properly administrate a DSAPT within the specific state. These include requirements that at least some assets be held and administrated within that state, and, generally, that there be at least one trustee located within the DSAPT state.[129] Generally, the trustee can be an individual, a trust company, or a bank.[130]

Although there is constant debate as to which state has the best DSAPT laws, because of its two-year statute of limitations, Nevada very well may have a competitive advantage over the other states that have similar DSAPT asset protection laws.[131] All other states that have DSAPT laws similar to Nevada have a four-year statute of limitations except for Utah and South Dakota, which have three-year statutes of limitations. With respect to non-preexisting creditors, Nevada law protects the transferred assets beginning two years after the date of transfer. [132] With respect to preexisting creditors, Nevada law protects the transferred assets beginning the later of two years after the date of transfer or six months after the creditor discovers the transfer or reasonably should have discovered the transfer. Under Nevada law, a creditor is deemed to have discovered the transfer at the time a public record is established such as the recording of a deed or assignment.[133]

Because of the difference in the period of the statute of limitations from one state to the next, there is an interesting ethical and malpractice issue with respect to advising clients on the appropriate DSAPT state for the client. This article will not offer an opinion or enter into the debate as to what is the most appropriate DSAPT state other than to pose the following scenario: Suppose a client establishes a DSAPT in a state that has a three or a four-year statute of limitations and they are then subject to a significant creditor claim in year three or four. This issue could seriously threaten the validity of the DSAPT itself

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128. *See id.*

129. *Id.*

130. *See* 18 ILL. PRAC. EST. PLAN & ADMIN. § 90:7 (4th ed.).

131. *See* NEV. REV. STAT. §§ 166.010-170 (1999).

132. *Id.* Common law and current statutes generally divide creditors into three categories. First, present creditors (a "pre-existing" creditor) generally exist when a transferor or debtor makes a transfer after a contract obligation with the creditor or claimant has been signed or after the claimant's cause of action has accrued. *Id.* A present creditor is a creditor whose claim arose before the transfer was made and the obligation was incurred. *Id.* Second, subsequent creditors refers to a narrow group of creditors who appear on the horizon after the time of the transfer. *Id.* Generally, it is necessary for the subsequent creditor to establish a causal link between the fraudulent disposition and the injury incurred, and the creditor must be reasonably foreseen by the transferor. This means a subsequent creditor is a creditor whose claim is reasonably foreseen as arising in the immediate future. A subsequent creditor does not exist unless the transferor can reasonably foresee incurring the cost of a claim or judgment at the time of the conveyance. Third, Potential future creditors are creditors other than present creditors and subsequent creditors. They are persons or entities who, in the normal course of business, happen to become creditors of the transferor sometime in the unforeseeable future. Basically, this means persons whom the creditor had no awareness of and could not reasonably foresee when the transfer was made.

133. *See* § 166.170(2).

and expose the DSAPT's assets to the judgment creditor. If the client was never advised properly as to the potential asset protection differences resulting from these statute of limitations, and the client later discovers that he or she could have established a DSAPT in Nevada (which only has a two-year statute of limitations), the estate planner may be subject to an action for malpractice or an ethical complaint.

Generally, DSAPTs are best suited for clients who are either worth several million dollars or are clients such as doctors and business owners engaged in high risk professions. Both now and in the future, the level of risk faced by the client is probably the most important factor to analyze to determine whether a DSAPT structure is appropriate for the individual client. Obviously, the ideal candidate for a DSAPT is one who has sufficient net worth so that both the legal fees and costs of establishing the trust and the ongoing administration costs of the structure are relatively small in comparison to the value of the assets that are protected both now and in the future.

When establishing a DSAPT for a client who is not a resident of the DSAPT state, there are significant conflict of law issues regarding which state law will apply with respect to the validity of the trust, the transfer of assets to the trust, and to the applicable creditor rights.[134] Personal property, such as cash and marketable securities that are transferred to and administrated in the DSAPT state, should be protected under the laws of the DSAPT state.[135] Because real estate transferred to a DSAPT may be subject to "in rem" jurisdiction in the state where the real estate is located, consider transferring the real estate to a limited liability company which is established pursuant to the laws of the DSAPT state.[136] The interest in the LLC is personal property, and, therefore, should be subject to the laws of the DSAPT state enabling the client to obtain the desired asset protection. Planners should also consider using a DSAPT state, such as Nevada, which has laws with respect to limited liability companies that make a charging order the sole remedy of a judgment creditor.[137] This structure strengthens the asset protection features of the DSAPT.

B. Super-Charging Asset Protection Planning—Combining an Asset

134. *See supra* note 104.
135. *See infra* text accompanying note 143.
136. *See id.*
137. Generally, the FLP/FLLC laws of most states restrict the remedies of a judgment creditor against the owner of an interest in an FLP/FLLC to a "charging order." A charging order entitles the creditor to receive distributions made with respect to the FLP/FLLC interests held by the debtor. Importantly, the charging order does not allow the judgment creditor to take actual ownership of the FLP/FLLC interests, and, therefore, the creditor has no immediate means of satisfying the judgment against the assets in the entity even though the creditor holds a judgment against one of the entity owners. Generally, the judgment creditor merely holds an assignee's interest in the FLP/FLLC and is never admitted or entitled to the rights of a partner or member. In addition, even if the FLP/FLLC does not distribute its income, the creditor/assignee still must pay income tax on the "phantom income" reported to the IRS on Schedule K-1, a very undesirable result.

Protection Trust with Two LLCs

One of the most powerful asset protection structures is to combine a DSAPT with two LLCs established under the laws of a state, such as Nevada, which makes the charging order against the owner of an LLC interest the sole remedy of the creditor. This particular strategy, which originated with attorney Steven J. Oshins of Nevada, is particularly valuable to a client who is a resident of a jurisdiction other than a DSAPT state because the structure adds an important second wall of defense against creditor claims.[138] The combination of a DSAPT with two LLCs is particularly powerful in Nevada because of Nevada's specific DSAPT and LLC laws.[139] A charging order is a lien; importantly, a creditor with a charging order against an LLC membership interest cannot obtain control of the LLC or force a distribution from the LLC.[140] By using Nevada LLCs, where the charging order is the exclusive remedy of a judgment creditor, if the client is sued and the plaintiff gets a judgment, the plaintiff can only get a charging order against the LLC membership interest. However, this is subject to certain judicially created exceptions, such as for a single member LLC or certain claims in a bankruptcy. Since the client can be the operating manager of each LLC, the client has complete investment control over each LLC. Therefore, the combination of a Nevada LLC and a Nevada DSAPT puts up two walls of defense against creditor claims that on the surface seem insurmountable. This is especially important for non-residents of a DSAPT state because the non-resident's level of protection that can be obtained using a self-settled domestic asset protection trust has not yet been decided by a court of law. Oshins opines that presumably the "DSAPT/Two LLC" strategy is successful because plaintiffs are settling cases rather than trying to pierce through this structure.[141] The perception of the double protection encourages settlement.

C. Illustration of the DSAPT/Two LLC Strategy

The structure of this planning technique is described as follows and is illustrated in Exhibit C.[142] The client creates two LLCs; each LLC will have both voting and non-voting interests:

1. LLC #1: The 1% voting interest and 98% non-voting interests are owned by the client's revocable trust. A 1% non-voting interest is owned by LLC #2. The client will be the operating manager of LLC #1. This

138. *See* Robert L. Moshman, *Nevada-nizing Asset Protection*, THE ESTATE ANALYST, Mar., 2009.
139. *See id*.
140. *See id*.
141. *See id.*
142. *See* discussion *infra* Part II.C.; Exh. C.

will be the fund that the client normally will live out of since their revocable trust will receive 99% of the distributions made from the LLC.

2. LLC #2: The 1% voting interest is owned by the client's revocable trust and the 99% non-voting interests are owned by a Nevada DSAPT (hereinafter in this section IV(C) referred to as the "NAPT"). The client is the operating manager of LLC #2. This LLC acts as a "rainy day fund" since the client's revocable trust receives only 1% of the distributions made by the LLC and the NAPT receives 99% of the distributions. The distribution trustee of the NAPT can make distributions to or for the benefit of the client if necessary. This is helpful for example, if the client is sued and loses access to all of their assets. Normally the authors recommend that the distribution trustee should be an independent trustee subject to removal and replacement by the client pursuant to the standards of Rev. Rul. 95-58.[143]

As long as no one sues the client, the client can live freely out of LLC #1 by making 99% of the LLC distributions to their revocable trust which, of course, they control. If the client is sued and the creditor obtains a charging order against that 99% LLC interest, the client will immediately "turn the spigot off" and stop making distributions from LLC #1, because 99% of these distributions will have to be paid to the creditor.

The client then will start living out of LLC #2 by making 99% of its distributions to the NAPT and living out of that trust like a "trust fund baby," assuming the protection holds up (i.e., the client is past the statute of limitations period, there are no fraudulent conveyance issues, there are no conflict of law issues between states, etc.). This combination of two Nevada LLCs with the NAPT should result in a favorable settlement for the client after their creditor's attorney realizes how this structure should play out. The client should use the DSAPT/Two LLC strategy as a tool to negotiate very favorable settlements with creditors by showing them that they are unlikely to be able to collect very much, even if they spend the time and money necessary to obtain a valid judgment enforceable in the state of Nevada.

Because of the need to live out of LLC #1 until there is a creditor attack, there must be sufficient assets in LLC #1 for the client to use for their personal living expenses. Also, there should be sufficient assets in LLC #2 so that the client can threaten to live out of LLC #2 if the creditor refuses to settle a dispute.

D. Other Planning Considerations

There are other planning issues that advisors must consider before implementing a DSAPT structure. For example, Section 548(e) of the

143. I.R.B. 1995-36, 16 (Sept. 5, 1995).

Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 provides that a transfer of assets to a self-settled asset protection trust within ten years of filing for bankruptcy does not protect the assets if the transfer was made with the *actual intent* to hinder, delay, or defraud a creditor.[144] Obviously, it is very difficult to prove actual intent; however, a client with an old-and-cold DSAPT should not test the reach of this provision. Rather, the client should avoid bankruptcy altogether. Other important matters to consider before implementing a DSAPT structure include, but are not limited to, the following: conflict of laws issues; state tax laws (including, but not limited to income, death, franchise, excise, and intangibles taxes); specific state law issues regarding the choice of entities; and state and federal regulatory issues regarding entities, businesses, real estate, insurance, securities, and other investments.[145]

V. COMBINING THE BDIT AND DISCOUNTED FLP/FLLCS—THE IDEAL WEALTH TRANSFER AND ASSET PROTECTION STRATEGY[146]

A. Achieving the Client's Most Sophisticated Estate and Asset Planning Objectives

Regardless of the modern dynamics regarding both the mathematics of wealth planning and the complexities of family and business relationships, there still are planning goals typical of most clients. They desire to accomplish the most effective disposition of their assets with the least possible diminution in their personal wealth, and to retain control of their wealth consistent with their family goals and values. Modern wealth planning attempts to achieve

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144. *See* 11 U.S.C. § 548(e) (2005) (emphasis added).

145. *See supra* note 104.

146. The Beneficiary Defective Trust, the original version of the BDIT, was created by attorney Richard A. Oshins in the 1970s. *See also* Richard A. Oshins, Robert G. Alexander & Kristen E. Simmons, *The Beneficiary Defective Inheritor's Trust (BDIT)—Finessing the Pipe Dream*, CCH Practitioner's Strategies, (Nov. 2008); Richard A. Oshins, *The Beneficiary Defective Inheritor's Trust ("BDIT")* (2008), revised and edited with additions by Robert G. Alexander and titled *The Beneficiary Defective Inheritors Trust (BDIT): Creating the Ideal Wealth Transfer and Asset Protection Plan* (2009) (unpublished manuscripts, on file with the authors) [hereinafter Oshins, *Creating the Ideal Wealth Plan (2009)*]; Jerome M. Hesch & David A. Handler, *Evaluating the Sometimes Surprising Impact of Grantor Trusts on Competing Strategies to Transfer Wealth*, 68 N.Y.U. TAX. INST. ON FED TAX'N, (2009); Michael D. Mulligan, *Fifteen Years of Sales to IDITs—Where Are We Now?*, 35 ACTEC J.227 (2009); Steve R. Akers, *Transfer Planning, Including Strategies to Maximize Benefits of GRATs and Sales to Grantor Trusts Given Recent Market Declines,* (May 2009) (unpublished manuscript, on file with the author at Bessemer Trust, N.A.); Steven B. Gorin, *Beneficiary Grantor Trusts and PLR 200949012*, TAX MGMT. EST. GIFTS AND TRUSTS J. (2010); Gideon Rothschild, Douglas J. Blattmachr, Michael M. Gans, & Jonathan G. Blattmachr, *Alaska Trusts: IRS Rules Self-Settled Alaska Trust Will Not Be in Grantor's Estate,* (unpublished manuscript, on file with the authors); Jonathan G. Blattmachr, Michael M. Gans, & Elvina H. Lo, *A Beneficiary as Trust Owner: Decoding Section 78,* 35 ACTEC J. 106 (2009); Jonathan G. Blattmachr & Diana S. G. Zeydel, *Calculating the Grantor Portion of a Trust with a 5 x 5 Demand Power,* LISI EST. PLAN. NEWSLETTER (Jan. 2010), at 1575 *available at* http://www.leimburgservices.com.

each of these goals while at the same time meeting the individual, financial, and other planning needs of the client.

There are three components of modern wealth transfer planning: the squeeze, the freeze, and the burn.[147] Each of these three components is commonly employed in the sophisticated structuring of GRATs and note sales to IDGTs. However, a major drawback with almost all trusts used for modern wealth planning (including GRATs, IDGTs, ILITs, and QPRTs) is that all of these are trusts that a client creates for the benefit of someone other than the client themselves.[148] With a typical wealth planning trust, the client cannot directly control, use, and enjoy the assets transferred to the trust, nor can the client determine the ultimate disposition of the trust assets once the trust has been created.[149] Also, it is extremely difficult, and often impossible, for the client to modify or revise the trust to react to a multitude of possible changed circumstances downstream.[150] These limitations to the typical wealth planning trust prevent many clients from moving forward with appropriate estate planning. Clients love their children and grandchildren, but when push comes to shove, they love themselves more. As the authors will demonstrate throughout this article, the BDIT solves the problems endemic with most typical wealth planning trusts; therefore, with the BDIT otherwise reluctant clients will gladly implement appropriate estate and asset protection planning.[151] The BDIT accomplishes the estate planning objectives outlined above without running afoul of the "Pipe Dream Trust" planning issues.[152] Furthermore, when properly created, administered, and sitused in an asset protection state such as Alaska, Delaware, Nevada, or South Dakota, a BDIT can protect family wealth from wealth transfer taxes, certain state income taxes, creditors, business disputes, family disharmony, and divorcing spouses, all in perpetuity.[153]

147. *See* Oshins, *Creating the Ideal Wealth Plan (2009), supra* note 146 at 3. The "squeeze" refers to the valuation discount. *Id.* By exchanging discountable assets (generally, non-controlling interests in entities that do not have a viable market) for assets not subject to a valuation reduction, the discount is passed tax-free into the BDIT. *See id.* A "freeze" is an estate freeze. *Id*. The client will sell discounted assets (non-controlling interests in FLPs/FLLCs) to the BDIT and will receive a promissory note in exchange for the discounted assets. *Id.* The note will bear interest; so in reality, this technique will be a "leaky freeze" because the balance of the installment note and the interest paid pursuant to the note will be included in the client's estate. *Id*. The assets sold to the BDIT will continue to grow in value, but importantly, the growth will occur outside the client's estate. *See id*. The "burn" refers to the "tax burn" result of the trust beneficiary paying income tax on income earned by the trust. *Id*. For an excellent discussion of the "tax burn," *see* Hesch, *supra* note 146.

148. Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 5.

149. *Contra id*.

150. *Id.* at 4-5.

151. *Id*.

152. Hesch, *supra* note 146.

153. Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 4-5.

B. The BDIT—The Ideal Wealth Transfer and Asset Protection Trust

1. General Overview

The BDIT is one of the most powerful estate, tax, and asset protection strategies available to planning professionals.[154]

> Essentially, it is a third-party settled trust designed to: (1) give the Client (who is both a trustee and the initial primary beneficiary of the trust) control and beneficial enjoyment of trust property so that the Client can use and manage the trust assets without compromising the trust's ability to avoid transfer taxes at the Client's death, and (2) to protect the trust assets from the Client's creditors. After the death of the client (the primary beneficiary), control of the trust passes to subsequent primary beneficiaries, often on a *per stirpes* basis, subject to change through the exercise of a [limited] power of appointment [held] by the client. In addition to receiving control of the trust, the subsequent primary beneficiaries also receive the benefits of trust-owned property such as: (1) transfer tax avoidance, (2) creditor protection, including protection from a divorcing or separated spouse, and (3) potential income tax savings, including state income tax, by domiciling the trust in a state with no state tax on trust income.[155]

The most critical concept that empowers the BDIT is that assets received from a third party and retained in a trust that is properly structured are protected from unnecessary exposure to the client's "predators."[156] These predators include the IRS, judgment creditors, a divorcing spouse, disgruntled family members, and business partners.[157]

A standard third-party, discretionary trust becomes beneficiary-defective when it is drafted so that the primary beneficiary is treated as the owner of the trust for income tax purposes pursuant to the IRC's grantor trust rules.[158] This requires the beneficiary to pay the income taxes on the income generated by the trust and also permits the beneficiary to engage in tax-free transactions with the trust.[159] Significantly, this also allows trust assets to grow income-tax-free, which compounds the multi-generational accumulation of wealth in the trust.[160] "With respect to the beneficiary, a BDIT combines the benefits of a traditional intentionally defective grantor trust (IDGT) created for others with

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154. *Id.*
155. *Id.* at 5.
156. *Id.*
157. *Id.*
158. *See* I.R.C. §§ 671-79; Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 5.
159. *See* REV. RUL. 85-13, 1985-1 C.B. 184; Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 5.
160. Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 5.

the enhanced wealth transfer tax and asset protection advantages of a trust created and funded by a third party for the benefit of the beneficiary."[161]

The BDIT provides enhanced planning benefits (particularly through control, access, and enjoyment of trust property), and because of these benefits, many clients "can now enjoy the benefits of advanced wealth transfer and asset protection planning, with minimal personal, financial, and tax risk[s]."[162]

2. The Ideal Estate Plan

The BDIT enables a client to implement what could be the ideal wealth and asset protection plan because it includes all of the client's possible goals and desires while maximizing the client's control, use, enjoyment, and management of their wealth.[163] If a knowledgeable client were to design an ideal estate plan for themselves, the client would retain the following bundle of rights and benefits:

(1) Have access to the income from their property until their death;
(2) Have their assets available for their use and enjoyment until their death;
(3) Be able to manage, control, and use their property until death;
(4) Be able to decide who will receive their property at their death or during their lifetime if the client gives the property away;
(5) Retain the power to determine in what form and when their beneficiaries will ultimately receive the property;
(6) Have their property (and ultimately their descendants' property) protected from creditors, including divorcing spouses, in perpetuity;
(7) Receive income-tax benefits and estate-tax savings;
(8) Have their wealth held in trust outside of the wealth-transfer tax system in perpetuity; and
(9) Have the ability to "rewrite" the plan in order to react to changed circumstances.[164]

A properly designed BDIT will allow clients to successfully achieve the above attributes and create what may be the ideal estate plan.[165]

161. *Id.*
162. *Id.*
163. *Id.* at 6.
164. *Id.* at 3.
165. *Id.* at 7.

3. Planning Benefits for the Client/Beneficiary—The "Inheritor"

The BDIT can resolve several major dilemmas for estate planners.[166]

First, the strategy provides acceptable, non-threatening planning for clients who may be leery of establishing a comprehensive, lifetime, 'wealth-shifting' estate plan that benefits others to the exclusion of themselves even if the 'others' are the Client's spouse and family. In effect, the trust enables a Client to (1) put a protective wrapper around his or her assets, (2) continue to enjoy the management and benefits of the assets transferred to the trust, and (3) obtain important transfer tax and creditor protection benefits. In addition, since the Client's descendants will be included as [discretionary] beneficiaries of the trust [during the client's lifetime], their use and enjoyment of family wealth can be accelerated, yet controlled by the Client.

Second, the strategy provides a risk-free estate plan. Even if family relationships implode in the future, with a BDIT the Client never risks losing control and enjoyment of the trust assets or the opportunity to make the decision as to who receives the control and benefit of the wealth after [their] death. If the client made traditional estate planning transfer to the client's descendants but retained the power to alter the disposition of the property transferred, the assets transferred would be subject to estate tax inclusion. (IRC §§2036-2038). Because the power to alter the disposition of the BDIT is given to the Client by a third party, if the power is properly limited such that the Client cannot exercise the power in favor of himself, [their] estate, [their] creditors, or the creditors of [their] estate, the power does not cause inclusion in the Client's estate.

Third, even for Clients who are willing to consider alternative estate planning techniques, the BDIT appears to offer the maximum wealth and asset protection benefits at the least possible risk. Compared to a grantor retained annuity trust (GRAT), there is no survivorship requirement in order to obtain a wealth shift, and there is no estate tax inclusion period (ETIP) rule to preclude having the transaction exempt from the generation-skipping transfer (GST) tax immediately. Compared with a traditional installment sale to an IDGT, the special power of appointment (SPA) given to the client in the BDIT avoids gift tax exposure. More importantly, the wealth shift does not diminish the client's control and beneficial enjoyment over the property transferred. Indeed, the Client's economic security improves because the assets are no longer exposed to [the client's] potential claimants.[167]

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166. *Id.*
167. *Id.*

4. *Finessing the Pipe Dream*

The estate tax inclusion rules are different for individuals who make transfers to a trust and retain certain interests in that trust than from those rules for beneficiaries of a third-party settled trust.[168] There will be estate tax inclusion if a person makes a transfer to a trust for less than fair and adequate consideration, and there will be an inclusion if a person retains a prohibited right or interest in the transferred property.[169]

It is basic estate planning that a beneficiary of a trust established by a third party may be given substantial rights in that trust without causing estate tax inclusion.[170] These rights include the following:

> (1) the right to income; (2) the right to withdraw property from the trust based upon an ascertainable standard; (3) the unlimited (no standard) authorization to have an independent trustee distribute trust property to him/her; (4) the right to appoint (give) property to anyone other than him/herself, his/her estate or the creditors of either; (5) the right to 'use' trust property for virtually any purpose (a life estate); and (6) the right to manage the property.[171] Thus, a trust beneficiary may be given rights and benefits that a gratuitous transferor could not retain for him/herself.[172]

Although given the rights enumerated above, to maximize the tax and creditor protection benefits of the inheritors trust it would be most efficient to restrict these rights and structure the trust by making the trust a fully discretionary trust in which the distribution decisions are lodged solely in the hands of an independent trustee, and by giving the inheritor a special power of appointment (re-write power) and managerial control over the trust.[173] None of the rights listed immediately above will cause exposure to the IRS or other would-be claimants.[174]

Although a person cannot establish a trust agreement for themselves without adverse tax and creditor protection consequences, "when a trust is properly established and funded by someone other than the Inheritor, the elements of what appears to be a 'pipe dream trust' might be the quintessential estate planning arrangement, providing both transfer tax and creditor protection not otherwise obtainable by our Clients."[175]

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168. *Id*. at 8.
169. *Id*.; *see* I.R.C. §§ 2036-2038 (also known as the "string" provisions).
170. Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 8.
171. *Id*.
172. *Id*.
173. *Id*.
174. *Id*.
175. *Id*. at 9.

C. The Pipe Dream Trust—Combining the BDIT with Discounted FLP/FLLCs

> *Naive clients, if they are completely candid, will say that they want a gift that helps their children and saves taxes. However, they also want a chance to use the property for themselves in case of adversity, desire management power over the trust estate, and wish to decide later when the children will receive the property.*[176]

1. Component Parts of the Pipe Dream Trust

As stated above, there are certain goals common to most clients.[177] The Pipe Dream Trust is able to achieve these goals by saving taxes, providing "use and enjoyment of the transferred assets if needed or desired," providing managerial control, retaining the "right to decide who receives the property at death," and obtaining protection from creditors.[178]

2. Traditional Planning Problems

The traditional planning problems with respect to most trusts stem from the fact that "there is estate tax inclusion in the transferor's estate for gratuitous transfers with retained interest."[179] The IRC sets forth the circumstances when a transfer will be included in the transferor's estate.[180] All three of the following elements must exist for estate tax inclusion: (1) a transfer; (2) with retained interests or enjoyment of the transferred assets, or retained rights to control who enjoys those assets; and (3) said transfer is for less than full and adequate consideration.[181] If the transfer satisfies these elements, "it will result in full inclusion in the transferor's estate of the assets transferred to the trust (including growth);" essentially, the entire trust will be included in the transferor's estate.[182]

The inclusion may change the value of assets that are held in an FLP/FLLC from "valuation as a non-controlling interest to valuation as part of a control block," in addition to exposing the assets to taxation in the transferor's estate.[183] The IRS will aggregate and tax the included assets with the client's other includible assets.[184] Thus, a client who transfers the 99% non-voting interests in an FLP/FLLC to a "tainted" trust for their children, and

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176. *Id.*
177. *See id.*
178. *Id.*
179. *Id.*
180. *Id.*; *see* I.R.C. §§ 2036-2038.
181. Oshins, *Creating the Ideal Wealth (2009)*, *supra* note 146, at 9-10.
182. *Id.* at 10.
183. *Id.*
184. *Id.*

retains the 1% controlling interest, the client will have estate inclusion of all 100% of the interests in their estate with no valuation discounts.[185] This may result in substantial estate tax without sufficient assets to pay the tax, and "it also will adversely impact the ability to obtain the marital deduction since the tax bill must be paid which reduces the assets available to fund the marital deduction."[186]

3. Asset Protection

Generally, self-settled trusts are exposed to creditors.[187] However, limited exceptions exist for DAPTs.[188] Conversely, trust assets will not be subject to tax so long as the trust is properly structured and not for one's own benefit. Further, those assets in the beneficiary's estate are not subject to the beneficiary's creditors, irrespective of how large the trust grows.[189] All transfers to the trust by gift must be made by someone other than the beneficiary.[190] The beneficiary may engage in arms-length transactions with the trust if the beneficiary receives back the payment of assets in "money or money's worth" equal to or greater in value than the assets that the beneficiary transfers to the trust.[191]

4. Income Taxes

If the trust income is taxable to the beneficiary under subchapter J, then certain favorable results occur.[192] First, payment of income tax by the beneficiary with respect to income earned by the trust is the functional equivalent of a gift to the trust in the amount of the tax paid.[193] However, the payment of the tax is not a taxable gift by the beneficiary, nor is it a "prohibited transfer for gift tax purposes which would expose the trust to transfer tax or creditors."[194] Second, payment of the income tax with respect to the trust income reduces the beneficiary's own estate—the "Tax Burn."[195] Finally, "[t]ransactions between the trust and the beneficiary are income tax-free (essentially, for income tax purposes it is as if the trust did not exist)," and "[i]n-kind payments using appreciated assets from the trust do not create an income tax."[196]

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185. *Id.*
186. *Id.*
187. *Id.*
188. *Id.*
189. *Id.*
190. *Id.* at 11.
191. *See id.*
192. *Id.*
193. *Id.*
194. *Id.*
195. *Id.*
196. *Id.*

D. Overview—The Six Components of the BDIT Strategy

There are six components to the BDIT strategy, all of which are based on statutes and revenue rulings binding on the IRS.[197] Each individual component is a safe and commonly used technique in all advanced wealth planning.[198] Therefore, from a tax standpoint, the BDIT is a very safe transaction.

(1) IRC Chapter 13, GSTT Rules: A dynasty trust can be created for the benefit of a client's descendants and can last in perpetuity.[199]
(2) IRC Sections 671, 678: A trust can be created "which is a grantor trust for income tax purposes as to the primary beneficiary of the trust."[200]
(3) Rev. Rul. 85-13: With a trust that is "defective" for income tax purposes, gain is not recognized on sales to the trust (i.e. an IDGT or a BDIT).[201]
(4) Rev. Rul. 93-12: There are no family attribution "rules for family wealth transfer [tax] purposes (estate and gift tax) and for purposes of obtaining valuation discounts."[202]
(5) Rev. Rul. 2004-64: There are no additional gift or other tax consequences if the grantor pays the income tax with respect to the income earned by the trust.[203]
(6) IRC Sections 2514(e), 2041(a)(2): If the beneficiary of a trust allows a Crummey power of withdrawal to lapse during the period of time that he or she has the ability to exercise the power, there are no income or wealth transfer tax consequences to the beneficiary.[204] After the Crummey withdrawal right is allowed to lapse, if it has lapsed within the "5% or $5,000" protection of the statute, there are also no subsequent down-stream income or wealth—transfer tax consequences to the beneficiary.[205]

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197. *Id*. at 12.
198. *See id*.
199. *See id*.
200. *Id*.
201. *Id*.
202. *Id*.
203. *Id*.
204. *Id*.
205. *Id*. "[T]he IRS's consistent ruling policy is that for purposes of IRC § 678, a lapse and a release [of a power of withdrawal] have the same effect, [and, therefore,] the beneficiary remains taxed as the owner of the trust under IRC § 678(a)(2) subsequent to the lapse." *Id*. at 25. There have been many Private Letter Rulings addressing this issue which is clearly "indicative of the IRS policy as to the taxation of a lapsing power." *Id*. Also, "[m]ost of the respected tax treatises recognize this issue and conclude that the best result is [to read] the terms 'lapse' and 'release'" as having the same meaning for purposes of IRC § 678. *Id*. "LTRs 20091008 and 20091009 (both issued on Dec. 3, 2008) illustrate the IRS position with respect to trusts funded with powers of withdrawal (. . . the respective trust beneficiary had the power to demand immediate possession and enjoyment of corpus or income.)." *Id*. "The rulings concluded, in relevant part: § 678(a) provides that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which: (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of §§ 671 to

For most clients there is no reason not to proceed with the BDIT.[206] "In addition to being a powerful estate planning technique [when] compared to alternative wealth shifting strategies, the BDIT strategy opens up planning to those . . . clients who otherwise will not proceed with their planning."[207] In effect, the technique enables clients to put a protective wrapper around their assets while continuing to control and enjoy the assets and obtaining transfer-tax and creditor-protection benefits.[208] Additionally, the descendants of the client can have their enjoyment of the family wealth accelerated if the client so desires because the client's descendants usually are included as discretionary beneficiaries of the trust.[209] These descendant beneficiaries will then receive the use and enjoyment of the trust assets immediately.[210] However, the use and enjoyment of the trust assets are controlled by the client as trustee of the trust; therefore, the BDIT is a safe strategy for the client.[211] If for some reason this strategy were to implode (which is highly unlikely), for the client who would otherwise do nothing else, the BDIT still is essentially risk-free for the reasons discussed throughout this section.[212]

For clients considering alternative estate planning techniques, the BDIT offers the maximum benefits and the least possible risk.[213] "Compared to GRATs, there is no survivorship requirement to obtain a wealth-shift and no ETIP rule to preclude having the transaction exempt from the GSTT immediately."[214] Compared to note sales to IDITs, the beneficiary/inheritor's special power of appointment avoids gift tax exposure under IRC Sections 2701 and 2702.[215]

An additional safeguard that can be built into the BDIT is to establish the BDIT in a state which allows self-settled trusts, such as Alaska, Delaware, Nevada, or South Dakota.[216] If the IRS were to successfully attack the BDIT strategy (which is extremely unlikely based on the safe-guards built into the strategy), nevertheless the BDIT would be a self-settled trust under applicable state law.[217] Therefore, the client's assets will still be protected from wealth transfer taxes and asset protected in perpetuity as a statutory self-settled trust with all of the planning features of the BDIT.[218]

677, inclusive, subject a grantor of a trust to treatment as the owner thereof. " (emphasis added). *See also* I.R.S. Priv. Ltr. Rul. 200949012 (Dec. 4, 2009) and I.R.S. Priv. Ltr. Rul. 200923024 (June 5, 2009) (which is a similar ruling in the context of an Alaska Self-settled Trust).

206. *See* Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 14.
207. *Id.*
208. *Id.*
209. *Id.*
210. *Id.*
211. *Id.*
212. *Id.*
213. *Id.*
214. *Id.*
215. *Id.*
216. *Id.* at 36.
217. *See id.*
218. *See id.*; *see also* Rothschild et al., *supra* note 148.

The BDIT will allow the client to sell discountable income-producing assets (e.g. S-corporation stock or FLP/FLLC interests) to the trust in exchange for an installment note, and the sale will be income tax-free.[219] The sales price will be the fair market value of the asset sold to the trust, and therefore, the client/inheritor will not have made a gratuitous transfer to the trust.[220]

E. BDIT Trust Design

The trust will be a fully discretionary, dynastic trust, and as the primary beneficiary, the client/inheritor will have a special power of appointment (SPA).[221] The SPA is important for two reasons: (1) to enable "the client and succeeding primary beneficiaries to 're-write' the trust as circumstances, family dynamics or laws change;" and (2) to prevent a "[c]ompleted gift from the primary beneficiary to the trust in situations where assets sold from the beneficiary to the trust are undervalued [for some reason]."[222]

The BDIT's "protection against an inadvertent gift tax appears to offer complete protection and is superior to the use of a defined value sale, which is often used to protect against a gift tax in the more traditional installment note sale."[223] Indeed, this protection from the gift tax makes the BDIT a "no-brainer" for someone who would not do alternate transfers, and is probably a safer alternative to the more traditional note sale to an IDIT.[224]

The trust will be a beneficiary-controlled trust where the client or the inheritor will be in control and will have the right to make all non-tax sensitive decisions (such as investment and managerial decisions), and will be able to control the identity of the Independent Trustee.[225] The independent trustee will make all tax sensitive decisions (including decisions regarding life insurance insuring the life of the client/inheritor and decisions regarding hard-to-value assets) and all discretionary decisions regarding distributions.[226] The client/inheritor will have the right to remove and replace the independent trustee.[227]

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219. Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 16-17; *see also* Rev. Rul. 85-13, 1985-1 C.B. 184.

220. Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 17; Rev. Rul. 85-13, 1985-1 C.B. 184.

221. Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 17.

222. *Id.*; Treas. Reg. § 25.2511-2(b).

223. McCord v. Comm'r., 461 F.3d 614 (5th Cir. 2006), rev'd, 120 T.C. 358 (2003). For a discussion of this issue, *see* Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 17.

224. Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 17.

225. *Id*.

226. *Id*.

227. Rev. Rul. 95-58, 1995-2 C.B. 191.

1. The Concept—Transfer Tax and Creditor Rights

The grantor of the trust for transfer tax and creditor rights purposes will be a third party; e.g., a parent.[228] The client/inheritor can be a trustee (in control of a beneficiary Controlled Trust) and a trust beneficiary.[229] However, the client/inheritor should never make a gratuitous transfer to the trust.[230] Any gift by the beneficiary to the trust will have the following adverse (and potentially disastrous) consequences:

> a. For income tax purposes—note sales will be partially taxable; payments 'in kind' will be partially taxable and the 'tax burn' will be reduced.
> b. For gift tax purposes—the gift will be a gift of a future interest.
> c. For estate tax purposes—there will be partial inclusion, which includes post transfer appreciation.
> d. For generation-skipping transfer tax purposes—the 'ETIP' rule will prevent allocation of the GST exemption, thus, creating a partially exempt and partially non-exempt trust.[231]

2. The Concept—Income Taxes

"The trust will be entirely a 'Beneficiary Defective Trust' so that during the [c]lient's lifetime, the [c]lient (individually) will be taxed on all items of . . . income, deductions and credits."[232]

There are three basic alternatives for trust income taxation with respect to discretionary trusts.[233] First, the general rule is that the trust is taxed on its income except to the extent distributed to the beneficiaries, "subject to the normal DNI rules."[234] Second, in a traditional IDGT, the trust settlor (grantor) pays the tax.[235] Third, with the use of a "beneficiary defective trust, the beneficiary pays the tax."[236]

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228. Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 22.
229. *Id*.
230. *Id*.
231. *Id*. at 23; *see also* I.R.C. § 2642(f) (2009).
232. Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 23; *see also* I.R.C. §§ 671, 678 (2009).
233. Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 23.
234. I.R.C. § 643 (2009).
235. *Id*.; I.R.C. § 671-77.
236. Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 23; *see also* I.R.C. §§ 671, 678 (2009).

a. Obtaining "Beneficiary Defective Trust" Status

"IRC [section] 678(a) provides the general rule that a person other than the grantor is treated as the owner of the trust income if that person has the power" to withdraw corpus or income from the trust.[237] A Crummey power of withdrawal is a power to withdraw the corpus.[238] This general rule applies unless the settlor also has a power that causes them to be taxed on trust income under IRC Sections 673-677 or Section 679.[239] Consequently, under Subchapter J a defect as to the trust settlor trumps an IRC Section 678(a) power.[240] Therefore, make sure when planning for beneficiary defective trust status that the settlor does not retain a power or operate the trust in a manner that would make the settlor the owner of the trust income.[241] "For example, do not have a BDIT acquire life insurance on the life of the settlor or the settlor's spouse."[242]

b. Benefits of Beneficiary Defective Trust Status

For income tax purposes, transactions between the trust and the owner of the trust (or their spouse) are income tax-free.[243] This includes in-kind payments in satisfaction of principal or income obligations.[244] By paying the income tax on the trust assets, the client is making the functional equivalent of a tax-free gift to the trust.[245]

> *[A] settlor sometimes wishes to be taxable on trust income that is nevertheless payable to an adult child whose tax bracket is comparable to that of the settlor. By paying the income tax that would otherwise be charged to the child, the settlor makes what amounts to an additional transfer to the child each year without having an additional taxable gift.*[246]

With the BDIT, placing the burden of the tax payment on the beneficiary/inheritor will achieve superior benefits to placing the obligation on the settlor because the beneficiary of the BDIT can get it back as a discretionary trust distribution if needed.[247] Also, for planning purposes it is

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237. Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 23.
238. *Id*.
239. *Id*.
240. *Id*. at 23-24.
241. *Id*. at 24.
242. *Id*.
243. Rev. Rul. 85-13; I.R.C. § 1041(a).
244. I.R.C. § 1041(a); Treas. Reg. § 1.1041(a) (2009).
245. *See* Professor Edward Halbach, *Tax-Sensitive Trusteeships*, 63 OR. L. REV. 381, 384 n.11 (1984).
246. *See id*.
247. *See* Richard A. Oshins & Gerald E. Lunn, Jr., *Trust Planning for the 21st Century: An Introduction to the Inheritor's Trust*, CCH Tax and Accounting (2004) *available at* http://www.oshins.com/images/Trust_Planning_for_the_21st_Centruy.pdf.

important to understand that the beneficiary/inheritor's payment of the income tax with respect to trust earnings is not a prohibited transfer within the scope of IRC Sections 2036 and 2038, and is not a gift for GST tax purposes; therefore, it is safer than a tax reimbursement provision.[248]

Payment of the tax reduces the beneficiary's wealth that would otherwise be exposed to estate tax and creditors. This effect is known as a tax burn.[249] Overtime, the estate tax benefits of the tax burn may far exceed the benefits of discounting.[250] In fact, given ample time the tax burn can result in sufficient wealth depletion so that the client may not need to file a Form 706 estate tax return because the estate is under the threshold filing limits.[251]

A concern often voiced when the settlor of the trust is taxed on the trust income (e.g., an IDGT) is that the success of the strategy ultimately can result in burdensome (and, perhaps, financially debilitating) income tax exposure for the settlor in the absence of a properly structured "discretionary reimbursement" provision.[252] Although many planners are concerned about the consequences of a tax reimbursement provision, the authors believe that a tax reimbursement provision for a settlor is safe if the trust is domiciled in a state, such as Texas or Nevada, which has statutes that protect the reimbursement from creditor rights. If the trust has a mandatory reimbursement provision, or if a creditor can enforce a judgment against a discretionary reimbursement provision, it is very likely that estate tax inclusion will result pursuant to IRC sections 2036 and 2041.[253] However, these issues are not a concern with planning in conjunction with a BDIT because it does not contain a tax reimbursement provision.[254] Rather, the beneficiary's personal financial security is protected because of access to discretionary distributions from the BDIT.[255] An additional income tax planning benefit of the BDIT is that the client is able to transfer cash or high-basis individually owned property to the trust in exchange for trust-owned, low-basis property.[256] As a result, the low-basis asset will obtain a step-up in basis at death as part of the settlor's estate.[257] This strategy is particularly meaningful if the low-basis (or better yet negative basis) assets being swapped are interests in depreciable real estate.

After the beneficiary dies, the trust generally will become a complex trust taxed under the normal DNI rules.[258] "Situsing and administering the trust in a

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248. *See* Rev. Rul. 2004-64.

249. Richard Oshins, *The Beneficiary Defective Inheritor's Trust ("BDIT")*, http://www.utcle.org/elibrary/preview.php?asset_file_id=22941.

250. *See* Hesch, *supra* note 146.

251. *Id*.

252. Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146.

253. *See id*.

254. *See id*.

255. *See id*.

256. *See id*.

257. I.R.C. § 1014(a); *see* Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146.

258. Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146*; see also* I.R.C. §§ 661-62, 643(a)(4) (West 2009).

jurisdiction that does not have state income tax . . . often can result in substantial benefits to the family in terms of income tax savings and, therefore, additional multi-generational wealth accumulation."[259]

F. A Traditional Wealth Planning Transaction—An Installment Note Sale to an IDGT

One of the most popular wealth transfer strategies "is the sale of discountable, income-producing property to an IDGT for an installment note."[260] However, remember that there are significant planning limitations with note sales to IDGTs. "Most often the planning is downstream—the beneficiaries of the IDGT are typically younger generation beneficiaries" and may even be the client's spouse.[261] Also, the client cannot be a beneficiary of or retain control over the trust, and the client will not have the power to change the ultimate disposition of the trust assets because such a power will cause inclusion in the client's estate.[262] Finally, "there is a potential gift tax issue if the property sold [to the trust] is undervalued, although most advisors believe that a 'defined value' transfer should solve this problem."[263]

G. A Better Wealth Planning Transaction—An Installment Note Sale to a BDIT and an Illustration of a Typical BDIT-FLP/FLLC Fact Pattern

The client owns 100% of a pass-through entity (FLP/FLLC) with a value of $50 million. Assume appropriate valuation discounts of 40% with respect to the FLP/FLLC interests. The client has a spouse, three children, and a parent who is willing and able to fund trusts for the client. The client's parent sets up three BDITs, one each for the benefit of the client and one of the client's children. The client, and the client alone, is given a Crummey power of withdrawal as to all gifts to the BDITs. The client sells one-third of the entity to each trust for installment notes equal in value to the entity interests being transferred—$10 million from each of the three trusts set up by the client's parent.[264] Thus, the client, generally the client's spouse, a child, and the

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259. *See* Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146; *see also* Bradley E. S. Fogel, *What Have You Done for Me Lately? Constitutional Limitations on State Taxation of Trusts*, 32 U. RICH. L. REV. 165, 194-95 (1998).

260. *See* Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146. An intentionally defective grantor trusts is an irrevocable trust intentionally drafted so that all of the trust income either is taxed to the trust grantor or a third party. I.R.C §§ 671-679 (2009).

261. *See* Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146. The authors generally use a "floating spouse" concept, e.g., "the one I'm married to and living with at the time of death or distribution." *Id*.

262. I.R.C. §§ 2036-2038, 2041.

263. *See* Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146.

264. *See id*. The primary reason for three trusts in the illustration is to be able to obtain valuation discounts by selling a one-third interest in the discounted FLP/FLLC to each trust.

descendants of the child will be beneficiaries of each trust. If the client owns only a non-controlling interest in the entity, a single trust generally will suffice.

"An ancillary reason for using a separate trust for each of the client's children (even if the client owns only a non-controlling interest in the entity) is that it enables the client to treat each child differently." For example, consider a client, age forty-three, who has three children who are in school. It is anticipated that at the age of seventy the client will have adult children with varying interests and needs. In such instance, the client's entrepreneurial child could use that child's separate trust, with the consent of the client as managing trustee, to own a business, thereby preserving the upside reward for the client and protecting the other children from the downside risk.

Because the BDIT is funded solely by the parent, the trust property will be protected from both the client's and the other beneficiaries' creditors, and will be outside of the transfer tax system for the duration of the trust. If the trust is set up in a state with no rule against perpetuities, the trust-owned property is forever protected from the transfer tax system and creditors.[265]

Only the client will be given a power of withdrawal over the entire contribution to each BDIT, and the parent will not retain any powers which will create grantor trust status as to the parent. As a result of the power of withdrawal, the client/beneficiary is treated as the owner of the trusts for all income tax purposes.

The parent is entitled to the gift tax exemption for the portion of the gift(s) that is within the gift tax annual exclusion; the remainder (if any) will be a taxable gift protected by the $1 million limit on the donor's gift tax applicable exclusion amount. The entire gifted amount will be GST tax exempt by reason of the allocation of a portion of the donor/parent's GST tax exemption.

Planning Note: Neither the client's children, the client's spouse, nor any other trust beneficiary (other than the client) can be given powers of withdrawal. Even though giving withdrawal rights to additional beneficiaries could be efficient for certain gift tax purposes because the withdrawal rights could increase the number of present interest annual gift tax exclusions, it will destroy the income tax planning critical to the success of the BDIT.[266] In order to make the BDIT a 100% grantor trust as to the client/inheritor, only the client/inheritor can be given a Crummey right of withdrawal.

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265. *Id*. Alaska, Delaware, New Hampshire, Rhode Island, South Dakota, and Wisconsin currently do not have rule against perpetuities laws. The states which permit very long trusts are: Florida (360 years), Nevada (365 years), Utah (1,000 years), Washington (150 years), and Wyoming (1,000 years). *See* Thomas R. Pulsifer and Todd A. Flubacher, *Dynasty Trusts* (2007), http://www.mnat.com/assets/attachments/Dynasty-Trusts.pdf.

266. I.R.C. § 2503 (2009). For 2010, the annual exclusion is $13,000 per year per donee. With respect to gifts in trust, *see* the following cases which authorize the leveraging of the annual gift tax exclusions pursuant to Crummey powers. M. Cristofani Est., 97 T.C. 74 (1991); L. Kohlsaat Est., 73 T.C.M (CCH) 2732, (1997), I.R.S. Tech. Mem. 1997-212 (May 7, 1997); *but see* I.R.S. Tech. Adv. Mem. 9,628,004 (Apr. 1, 1996) *and* Tech. Adv. Mem. 9,731,004 (Apr. 21, 1997).

Critical Planning Note: The authors acknowledge that there may be substantial authority to the effect that the initial gift from the parent to the trust can exceed $5,000, and that the Crummey withdrawal right held by the client/beneficiary can be a "hanging" power of withdrawal over all contributions to the trust which will lapse each year as to the greater of 5% or $5,000. Therefore, even with a larger initial gift, the trust will be treated entirely as a grantor trust as to the client/beneficiary. However, so that there is absolutely no question that the lapse of the Crummey withdrawal right by the client/beneficiary (the primary beneficiary of the trust and the only beneficiary given the withdrawal right) will cause the entire trust to be treated as a grantor trust as to the client/beneficiary for all income tax purposes (IRC sections 671 & 678), the authors strongly recommend that the client's parent only contribute a total of $5,000 to each of the three trusts, i.e. $1,666.66 to each individual trust. This seems to be the safest strategy to ensure that the BDIT is always 100% a grantor trust as to the client/beneficiary and *only* the client/beneficiary.

The client will sell discountable interests in the entity (one-third to each BDIT) for the appraised fair market value of the interests being sold. Assuming an entity value of $50 million and a valuation discount of 40%, the client will receive three notes of $10 million each. The notes usually will be interest only with a balloon payment.[267] Generally, installment note sales to IDGTs and BDITs use interest rates based upon the IRS tables for the month of the transaction.[268] However, consider charging market rates of interest rather than the rates under IRC Section 1274(d) which typically are used for traditional note sales.[269] The reason is that there is concern that a bankruptcy court might not accept the IRS tables, and, because the seller is also a beneficiary of the trust, the transfer will not be for "fair value" in the eyes of a bankruptcy judge exposing the trust's assets to creditors in a bankruptcy.[270] This also would expose the transfer to estate tax inclusion under IRC Section 2041.[271]

H. Life Insurance Planning with a BDIT

The BDIT can be used as a funded irrevocable life insurance trust (ILIT).[272] The trust can buy life insurance that insures the life of anyone on whom the trust has an insurable interest.[273] Generally, the life insurance will be on the life or lives of one or more of the trust beneficiaries.[274] If the life insurance is owned on the life of the inheritor/client, two adjustments must be

267. *See* Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146.
268. *Id.*
269. *Id.*
270. *Id.*
271. *Id.*
272. *Id.* at 35.
273. *Id.*
274. *Id.*

made in the trust design in order to avoid estate tax inclusion under IRC Section 2042:

> [a] all decisions with respect to the life insurance on the inheritor/insured's life must be made by a non-insured trustee (the authors generally use an independent trustee for these decisions); and
> [b] the insured, as beneficiary, cannot have a power of appointment over the life insurance or its proceeds. However, a non-insured, independent trustee or a trust protector can have the discretionary power to allocate distributions as well as the power to change the trust beneficiaries who might be the recipients of the insurance proceeds.[275]

With respect to the BDIT purchasing life insurance, attorney Larry Brody points out that until there is adequate cash flow to pay premiums (and fund the installment note) the strategy will either involve using a donor/donee split-dollar arrangement or a premium financing transaction, either with the insured or with a third-party lender loaning money to the trust to provide a source of premiums.[276] Attorney S. Stacy Eastland suggests that in view of the IRS revision of the split-dollar regulations, in the right situations practitioners might consider utilizing the technique known as the "reverse partnership freeze" in order to pay premiums on large life insurance policies without paying significant gift tax.[277]

I. The BDIT and Buy-Sell Planning

Life insurance owned by the BDIT could be used for the purposes of buying and selling.[278] This is a variation of the BILIT concept devised by Stephen O. Rothschild, C.L.U.[279] Assume A and B together own an entity 50-50. The traditional buy-sell agreement is designed so that each person owns life insurance on the other person's life.[280] At the first death, the survivor purchases the decedent's interest and then owns 100% of the entity. Alternatively, if a BDIT owns life insurance on the co-owner's life and purchases the decedent's interest at death, the survivor will own 50% of the entity and the BDIT will own 50% of the entity.[281] If the survivor redeems or transfers 1% of his/her individual ownership in the entity, he/she individually will own a discountable 49% minority interest in the entity for estate tax

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275. *Id.*
276. *Id.* at 36.
277. Eastland, *supra* note 47, at 141.
278. *See* Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 55.
279. *See id.*
280. *Id.*
281. *Id.*

purposes, but as trustee of the BDIT he/she will be in full control of the entity.[282]

J. The BDIT – FLP/FLLC Life Insurance/Premium Financing Strategy

Attorney Michael D. Mulligan of St. Louis, Missouri, suggests an interesting alternative to the standard ILIT (an alternative which also can function as a sophisticated premium financing technique) which he refers to as the "Life Insurance/Limited Partnership Sale to IDIT technique."[283] This strategy, which will work equally well with a BDIT, is structured as follows. An individual transfers income producing assets to an FLP/FLLC in exchange for discountable entity interests. The FLP/FLLC then can acquire life insurance on the individual's life, and the entity will be the owner and named beneficiary of the insurance.[284] The individual will then sell their discounted FLP/FLLC interests to a BDIT in exchange for the trust's installment promissory note (using applicable valuation discounts). After the sale, income from liquid assets that the individual has transferred to the FLP/FLLC can be used to pay the insurance premiums.[285] Because the FLP/FLLC owns and is the beneficiary of the life insurance, the premium payments will not have any gift tax consequences.[286] Although the insurance is acquired with the funds which the insured transfers to the discountable FLP/FLLC, the insured never possesses any incidence of ownership with respect to the insurance, and the insurance is not includable in the insured's estate.[287] If the insured is unable or unwilling to make a single contribution to the FLP/FLLC of sufficient size to support the premiums due on the insurance held by the FLP/FLLC, consideration might be given to providing in the entity agreement that the insured's contribution to the entity is to consist of a contractual amount to be paid each year for a specified period of time.[288] The amount of the annual contributions and the period of time the contributions are to continue will be coordinated with the anticipated needs for premiums payments.[289]

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282. *Id*.

283. Mulligan, *supra* note 146.

284. *See id*.

285. *See id*.

286. *See id*.

287. If the FLC/FLLP interests are sold to a BDIT, the sale eliminates any impact on the value of the insured's estate as a result of the insurance proceeds being paid at death. Treas. Reg. § 20.2042-1(c)(6) (2007). Because the limited partnership interests are owned by the BDIT, any increase in the value of those interests as a result of the receipt by the FLP/FLLC of life insurance proceeds does not increase the value of the insured's estate. *Id*. If the individual does not sell the FLP/FLLC interests to the BDIT and dies owning the FLP/FLLC interests, even though the insurance death benefits are not included in the individual's estate pursuant to I.R.C. § 2042, they will be taken into account in determining the value of the FLP/FLLC interests which are includable in the individual's estate under I.R.C. § 2033. *Id*.

288. Treas. Reg. § 20.2042-1(c)(6) (2007).

289. Mulligan, *supra* note 146. Mulligan expresses concern that the I.R.S. will rule that the formation of an FLP/FLLC holding life insurance as its only asset does not satisfy the "bona fide" sale for an adequate and full consideration requirement of I.R.C. § 2036(a), and that the I.R.S. will not consider the FLP/FLLC as

The wealth shifting opportunities with this strategy obviously can be enhanced by a combination of one or more of the strategies discussed throughout this article with respect to combining grantor trusts and FLP/FLLCs, including (1) maintaining control and beneficial enjoyment of the assets (the FLP, FLLC, and the life insurance) by using a BDIT; (2) increasing appropriate valuation discounts to fund the FLP/FLLC by using a Nevada Restricted Entity; and (3) solving the cash flow issues necessary to fund the strategy, including the life insurance premiums, by a combination of valuation discounts and planning with disregarded entities.[290]

K. The Cash Value BDIT

An additional, dynamic planning opportunity combining the BDIT and life insurance is a concept known as the "Cash Value BDIT."[291] Unfortunately, a complete discussion of this particular strategy is beyond the scope of this article; however, it undoubtedly creates what may be the most powerful private retirement and wealth accumulation strategy available to practitioners.[292]

L. Coordination with Asset Protection

"In today's increasingly litigious environment, however, asset protection planning is becoming increasingly significant as a separate area of focus within the field of estate planning."[293]

The typical asset protection plan integrates either a Foreign Asset Protection Trust (FAPT) or a Domestic Asset Protection Trust (DAPT) with one or more FLPs or LLCs.[294] With this strategy, typically the client will own a 1% controlling interest in the entity (the FLP/FLLC) so that they will manage the assets; the APT will own the remaining 99% non-controlling interests.[295]

The BDIT can provide more secure asset protection than either a FAPT or

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having been formed for legitimate and significant non-tax reasons which, therefore, will result in estate tax inclusion. *Id*. Consequently, Mulligan suggests that planners include a provision in the partnership/operating agreement directing that the proceeds of any insurance on a partner/member's life which is included in the partner/member's federal gross estate are to be distributed to the partner/member's estate or revocable trust. *Id*. This technique will ensure that such payment will make the proceeds available for the payment of any estate taxes which they may generate or, if the insured is survived by a spouse, the payments qualify the proceeds for the estate tax marital deduction. *Id*.

290. *See* Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146.

291. *See* Robert G. Alexander & Michael W. Halloran, *The Cash Value Beneficiary Defective Inheritor's Trust (The "Cash Value BDIT"): Creating a More Flexible and Comprehensive Wealth Accumulation and Retirement Plan*, N.Y.U. REV. EMP. BEN. & EXEC. COMP. ¶ 7 (2009).

292. *See id*.

293. *See* Fox, *supra* note 42.

294. *See* Alexander A. Bove & Marjory Suisman, *Coordinating an Asset Protection Plan with an Estate Plan – The Often Overlooked Essentials, in* 1 Asset Protection Strategies: Planning with Domestic and Offshore Entities (Alexander J. Bove, Jr. ed., 2002).

295. *Id*. at 3.

a traditional DAPT for the following reasons. Many case rulings suggest that courts do not respect the FAPT.[296] Many courts are suspicious of FAPT structures and seem to look for ways to disregard them, ultimately allowing creditors to reach the assets.[297] There are no reported cases on the validity of DAPTs; however, most lawyers in the field believe that DAPTs do work.[298] There are several cases that attempt to attack the validity of the DAPT itself and transfers to the DAPT; however, it is the authors' understanding that in each case where the DAPT was properly structured and administered the lawsuits were settled for pennies on the dollar.[299] The BDIT is not structured as a self-settled trust; therefore, it can be a safer asset protection structure than either a FAPT or a DAPT.[300] Because the BDIT is a third-party settled trust, it is unaffected by the legal issues and suspicion that attach to many self-settled trust structures.[301] In addition to the superior asset protection features of the BDIT, the BDIT can provide wealth transfer tax planning opportunities that are superior to either a traditional FAPT or a traditional DAPT.[302] The sale of non-controlling interests in an FLP/FLLC to a BDIT has the ancillary virtues of GST tax saving similar to what is obtainable by a sale from the inheritor.[303] The sale by the client of both the -controlling and non-controlling interests in the FLP/FLLC to a BDIT for their fair market value could enhance the client's asset protection because the BDIT then will own all of the entity interests.[304] The BDIT will enable the client as managing trustee to control the entity (FLP/FLLC) even if all the client's FLP/FLLC interests (both controlling and non-controlling) are transferred to the BDIT.[305] Finally, the transaction could be structured to change the estate tax value of the property in the BDIT to that of non-controlling interests.[306]

M. Further Illustration and Discussion of the BDIT FLP/FLLC Transaction[307]

The client/inheritor's parent gifts a total of $5,000 to separate BDITs for the client (the "inheritor") and the client's descendants. The inheritor has three children; therefore, three trusts are set up, each funded with a gift of $1,666.00—one each for the inheritor and a different child of the inheritor. The inheritor is given a power of withdrawal over the entire $5,000, making

296. *See* Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 56.
297. *Id*.
298. *See id*.
299. *See id*.
300. *Id*. at 10.
301. *Id*.
302. *See generally id*. (laying out different opportunities available).
303. *See id*. at 56.
304. *Id*.
305. *Id*.; *see also infra* Exh. D for an illustration of this strategy.
306. *Id*.
307. *See* Oshins, *Creating the Ideal Wealth Plan (2009)*, *supra* note 146, at 56-57.

them the owner of each trust for income tax purposes. The client's parent is the settlor of each trust for transfer tax and creditor's rights purposes.

Each separate BDIT is fully discretionary as to the inheritor, the inheritor's spouse, one of the inheritor's children, and said child's descendants. The inheritor is the family trustee and controls the identity of the independent trustee.

Assume that the inheritor owns 100% of a pass-through entity such as an LLC. Using a combination of the BDIT and the advanced planning techniques discussed throughout this article, the inheritor will be able to sell a one-third interest in the LLC to each separate trust in return for a note or a series of notes using market interest rates. Each sale is for the appraised fair market value of the LLC interest being sold, taking into account appropriate valuation discounts because the interest being sold is a non-controlling interest in a closely-held entity.[308] The notes are paid by means of the cash flow generated by the entity.

If the notes owed by each trust will cause the trust's debt-to-equity ratio to exceed 9:1, the inheritor's spouse, if the spouse has the economic wherewithal, may guarantee each sale in order to give the sale economic substance for transfer tax purposes.[309] Ideally, the spouse will guarantee at least ten percent (10%) of the value of notes owed by each trust. The spouse will be paid fair market value for providing the guarantees, which enables the wealth shift to occur without gift tax. Payment of the guarantee fees is income tax neutral if the inheritor is living because transactions between the trust and the inheritor's spouse are treated as transactions between spouses for income tax purposes.[310]

The following are the results of this transaction:

[a] the entity (LLC) is removed from the inheritor's estate on a discounted basis;
[b] the transaction results in a leveraged estate freeze for the inheritor;
[c] there is no income tax on the sales or the guarantees;
[d] all of the assets in the trusts are still available to and controlled by the inheritor;
[e] the inheritor has a SPA (re-write power);
[f] the taxable estate of the Inheritor is depleted by valuation discounts as well as payment of income taxes on the trust income (the "tax burn");
[g] the BDIT has both GSTT and estate tax exemption in perpetuity;
[h] the inheritor and the inheritor's family have creditor and divorce protection in perpetuity;

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308. *Id*. Remember, pursuant to Rev. Rul. 93-12 there is no family attribution for wealth transfer and valuation discount purposes. *Id*. at note 14.

309. *Id*. For an excellent article discussing beneficiary guarantees, *see* Milford B. Hatcher, Jr. and Edward M. Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX. No.3, 152 (Mar. 2000).

310. I.R.C. § 1041(a)(1) (2010).

[i] the SPA prevents a gift tax on transactions with the trust; and
[j] otherwise resistant clients will move forward with planning.

The inheritor will not lose anything to anyone during the inheritor's life and will obtain creditor and transfer tax benefits for the inheritor and the inheritor's children in perpetuity. Finally, the inheritor's beneficiaries, who also are included as discretionary beneficiaries of the BDIT, can benefit from the property and receive distributions from the BDIT during the inheritor's life without gift tax consequences.

N. Conclusion

The BDIT should be one of the most important tools in the forward-thinking estate planner's tool box. From a wealth transfer and asset protection perspective, no other planning technique offers as much opportunity, flexibility, and protection from taxes and creditors as a BDIT. The BDIT allows the inheritor to do the following: (1) control the investment and management decisions with respect to the trust; (2) remove and replace an Independent Trustee; (3) rewrite the trust without adverse tax or creditor exposure pursuant to a special power of appointment; (4) control and enjoy the trust assets in a manner that is functionally equivalent to outright ownership of the trust property; (5) obtain the income tax, wealth transfer tax and asset protection benefits of a traditional dynastic intentionally defective grantor trust (IDGT); and (6) structure gifts, loans, life insurance, business, and investment opportunities through the trust all by means of a relatively risk-free, highly leveraged income and wealth transfer tax transaction.[311]

VI. ENHANCING THE WEALTH TRANSFER BY ADDING THE "DISREGARDED ENTITY" COMPONENT[312]

A. Introduction

As mentioned above, in addition to the use of trusts (particularly income tax defective dynasty trusts), pass-through entities (such as FLPs, FLLCs, and S-Corporations), and valuation discounting, the use of an entity which is disregarded for income tax purposes can solve many of the cash flow problems which often plague traditional wealth transfer planning, and, at the same time,

311. *Id.* The inheritor will not hold any powers over life insurance owned by the BDIT insuring the inheritor's life. *Id.*

312. Richard A. Oshins, Presentation at the NAEPC 46th Conference, *Estate Planning with Disregarded Entities*, Nov. 11-13, 2009, *available at* http://www.boiseepc.org/05oshinsLongPowerPointPresentation-Estate Planningwd.pdf.

significantly enhance the overall success of comprehensive wealth transfer and asset protection strategies.[313]

In situations where assets are transferred to a GRAT or an IDGT and the assets have little or no cash flow, or cash flow insufficient to meet the obligations created pursuant to the GRAT annuity or installment note, the use of a disregarded entity may be appropriate.[314] For purposes of this section, a disregarded entity is an entity that is recognized as a separate entity for state law purposes (and, therefore, wealth transfer tax purposes), but that is completely ignored for income tax purposes—it is an income tax nothing.[315]

Disregarded entities are also useful in situations where the entity has low-basis assets that are gifted or sold in the wealth shifting process.[316] From the standpoint of a comprehensive wealth plan, at some point in time it is advisable to transfer back to the client these low-basis assets in order for the assets to receive a step-up in basis at death.[317]

The combination of income tax defective trusts and disregarded entities may result in an estate planner's dream—transferring discounted assets into a trust and receiving back assets which are not subject to valuation discounts.[318]

B. A Disregarded Entity for Income Tax Purposes

The benefit of a disregarded entity is found in its opposing tax treatments. A disregarded entity is recognized for estate, gift, and GST tax purposes; however, for income tax purposes, the entity is deemed not to exist.[319] Importantly, because of these differing treatments, clients are able to obtain valuation discounts using disregarded entities.[320]

The IRS ruled that although a disregarded entity is not recognized for federal income tax purposes, the entity does validly exist as a separate legal entity under state law, and, therefore, state law controls the owner's rights and economic interests in the entity.[321] Consequently, state law benefits exist, such as planning that will allow valuation discounts and creditor protection if the entity is properly structured and combined with grantor trusts, even though the entity is disregarded for income tax purposes.[322]

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313. *Id.*
314. *Id.*
315. *Id.*
316. Robert G. Alexander, *Enhancing the Planning Value of GRATs, Part 2,* J. OF PRAC. EST. PLAN., Feb./Mar. 2009.
317. *Id.*
318. *Id.*
319. Rev. Rul. 2004-137, 2004-32 I.R.B.
320. *Id.*
321. *Id.*
322. *Id.*

There are several different types of entities and entity structures (the combination of two or more entities) that may be classified as a disregarded entity for income tax purposes.

1. A Single Owner Entity That Has Not Elected to Be Classified as an Association (Corporation) Is a Disregarded Entity

The IRC and Treasury Regulations provide that even though the entity exists and has certain rights under state law, its existence is ignored for income tax purposes, and it is treated as a tax nothing.[323]

2. An Eligible Entity with Two Owners Under Local Law Can Be Treated as a Disregarded Entity

In a Revenue Ruling, a corporation wholly owned an LLC.[324] The corporation and the LLC entered into a partnership under state law.[325] However, because the LLC was wholly owned by the corporation, the LLC was a disregarded entity as to the corporation, and, therefore, for income tax purposes, the corporation owned the partnership.[326]

3. Additional Structures Where an Entity with Two Owners May Be Treated as a Disregarded Entity

1) An individual and an income tax defective trust together in a partnership;
2) An FLP which owns 100% of an LLC; and
3) An FLP together with an LLC if 100% of the LLC is owned by an individual and the remaining FLP interests are owned by the same individual.[327]

4. The Check-the-Box Regulations Classification That the Entity is Disregarded Will Not Prohibit the Use of the Willing Buyer/Willing Seller Valuation Rules and the Applicable Regulations for Transfer Tax Purposes in a Hypothetical Transaction[328]

General principles of tax law provide that state law determines the characterization of the entity interests transferred in the valuation process.[329]

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323. I.R.C. § 7701; Treas. Regs. §§ 301.7701-1(a), 301.7701-2(c)(2).
324. Rev. Rul. 2004-77, 2004-2 CB 119.
325. *Id.*
326. *Id.*
327. *Id.*
328. Pierre v. Comm'r, 133 T.C. No. 2 (Aug 2009).
329. *See* United States v. Nat'l. Bank of Commerce, 472 U.S. 713, 722 (1985); United States v. Bess, 357 U.S. 51, 55 (1958); Morgan v. Comm'r, 309 U.S. 78 (1940).

Recently however, both the IRS and the courts have tended to ignore this rule and have applied a step transaction analysis to ignore the state law recognition of the entity separate from the taxpayer and, therefore, have disallowed otherwise appropriate valuation discounts.[330] Fortunately, in an important victory for taxpayers the Court in *Pierre v. Comm'r* held as follows:

> [W]hile we accept that the check-the-box regulations govern how a *single-member LLC* will be taxed for Federal Tax purposes, i.e., an association taxed as a corporation or as a disregarded entity, we do not agree that the check-the-box regulations apply to disregard the LLC in determining how a *donor* must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC . . .To conclude that because an entity elected the *classification* rules set forth in the check-the-box regulations, the long established Federal gift tax valuation regime is overturned as to single-member LLCs would be 'manifestly incompatible' with the Federal estate and gift tax statutes as interpreted by the Supreme Court.[331]

C. A Closer Look at the Pierre *Case*

The *Pierre* case is an excellent illustration of how to successfully structure wealth shifting strategies in combination with disregarded entities as discussed throughout this article.[332] Therefore, it is worth taking a closer look at the facts and holding of the case. The petitioner, Suzanne J. Pierre (Pierre), created a single person LLC in July 2000 pursuant to New York law.[333] Under the Treasury Regulations (the check-the-box regulations), Pierre elected not to treat the LLC as a corporation for federal tax purposes.[334] On September 15, 2000, Pierre funded the LLC with cash and marketable securities.[335] Subsequently, on September 27, 2000, Pierre gifted a 9.5% membership interest in the LLC to each of two trusts she created on July 24, 2000 so that she could use a portion of her then available credit amount and her GST exemption—one for the benefit of her son and one for the benefit of her granddaughter.[336] She then sold to each of the trusts a 40.5% membership interest in the LLC in exchange for secured promissory notes.[337] The notes were discounted by 30% for lack of marketability and lack of control.[338] Therefore, she paid no gift tax with respect to any of the transfers.[339] Pierre argued that the transfers to the trusts should not be treated as transfers of the

330. *See* Senda v. Comm'r, 433 F. 3d 1044, 1049 (8th Cir. 2006).
331. *Pierre*, 133 T.C. No. 2 at 8.
332. *Id*.
333. *Id*.
334. *Id*.
335. *Id*.
336. *Id*. at 2.
337. *Id*.
338. *Id*.
339. *Id*.

underlying assets of the LLC even though the single member LLC was treated as a disregarded entity for income tax purposes under check-the-box regulations.[340] The Tax Court noted that pursuant to the Supreme Court's ruling in *Morgan v. Comm'r*, state law establishes the applicable property rights and interests of the LLC, and federal law defines the tax treatment of those rights.[341] After examining applicable state law, the Court concluded that Pierre did not have an interest in the underlying assets of the LLC.[342] It further determined that the check-the-box regulations did not govern the federal gift tax valuation issues regarding Pierre's LLC.[343] Accordingly, the court held that the transfers to the trusts should be valued for federal gift tax purposes as interests in the LLC and not as interests in the underlying assets.[344]

This decision is critically important with respect to the discussion of disregarded entities and valuation discounts that are woven throughout this article. It holds that a single member LLC which is validly organized for state law purposes, but is not recognized as a separate entity for federal income tax purposes (a disregarded entity), can be recognized as a valid separate entity for wealth transfer tax purposes including the application of appropriate valuation discounts.[345]

VII. GRATS WITH DISREGARDED ENTITIES

A. *Discussion and Analysis*

GRATs may be used with disregarded entities to significantly enhance the client's wealth shifting objectives. To use this technique, the client transfers discountable, income-producing assets to the trust in exchange for an annuity. The annuity payments are paid from the cash flow generated by the gifted property. Closely held businesses which are flow-through entities for income tax purposes (such as FLPs, FLLCs, and S-Corporations) are excellent examples of assets that will generate the cash flow necessary to make the annuity payments.

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340. *Id*. at 3.

341. *Id*. at 4; Morgan v. Comm'r, S. Ct. 40- USTC ¶ 9210, 309 US 78, 60 S. Ct. 424.

342. *Pierre*, 133 T.C. No. 2 at 4.

343. *Id*. at 8.

344. *Id*. at 9.

345. *Id*. Ten judges joined in the majority opinion. *Id*. There were vigorous dissents to this decision by six of the judges. *Id*. Many commentators opined that this decision may be appealed by the IRS. *See* Steve R. Akers, *Akers on Pierre,* Steve Leimburg's Estate Planning Newsletter (Sept. 3, 2009), *available at* http://www.leimburgservices.com (providing commentary regarding the *Pierre* decision). *See also* Pierre v. Comm'r, T.C. Memo. 2010-106 (May, 13, 2010) ("*Pierre* II"). The Court reviewed certain step transaction and valuation issues. Importantly, the Court did not overturn the issues regarding the single member LLCs as valid, separate entities for state law purposes but did allow the entities to be disregarded for federal income tax purposes.

Treasury regulations require that the trust pay the annuity payment at least annually.[346] If there is insufficient cash available to make the annuity payment, the trust will have to make the payment in-kind with a portion of the transferred assets.[347] However, in this situation, the transfer of wealth is less effective because regulations require that the valuation applied to the assets during the original transfer of assets to GRAT also apply to the discount on any payments made in-kind.[348] In addition, the expense of new asset appraisals will be required.[349] Although GRATs are generally considered safe transactions from a valuation standpoint, that safety exists for the initial funding and not for the payment of the annuity.[350] Finally, keep in mind that GRAT payments made in-kind leak wealth from the trust back to the grantor and adversely affect both the wealth transfer and asset protection built into the trust.

B. Countering Weak GRAT Cash Flow

There are several techniques a client may use to counter a weak cash flow generated from the assets transferred to the GRAT. First, with the use of a graduated GRAT, increasing the annuity payment by 20% per annum will permit lower initial annuity payments, which will allow the GRAT assets to grow in value.[351] Therefore, because of the enhanced growth of the GRAT assets, the GRAT eventually will generate a sufficient amount of cash flow to pay the annuity in cash rather than in-kind with discounted GRAT assets.[352] Also, if the cash flow is moderate relative to the value of the property (which, for example, often occurs with real estate), planners may extend the initial term of the GRAT in order to pay the annuity in cash.[353] An extended term could also result in a significant reduction in annuity payments in the early years.[354] This reduction in payments, as applied to the discounted initial gift, is often sufficient to handle annuity payments in the early years. Unfortunately, an extended term also extends the risk of estate tax inclusion if the grantor fails to survive the term of the GRAT.[355] This unfortunate result may be considered an acceptable risk by the client, or, in the alternative, may be countered by

346. Treas. Reg. § 25.2702-3(b)(1)(2005).

347. Treas. Reg. § 25.2702-3(b)(1)(ii) ("A fixed fraction or percentage of the initial fair market value of the property transferred to the trust . . . payable periodically but not less frequently than annually . . . .").

348. Treas. Reg. § 25.2702-3(b)(1)(iii)(2); I.R.C. § 1.664-2(a)(1)(iii).

349. *See* Robert G. Alexander, *Enhancing the Planning Value of GRATs, Part 2*, J. OF PRAC. EST. PLAN., Feb./Mar. 2009.

350. *See* Craig L. Janes, *Grantor Retained Annuity Trust: Avoiding the Petards in an Otherwise Safe Harbor,* 33 EST. PLAN. 10; *see also* Craig L. Janes, *Grantor Retained Annuity Trust: Avoiding the Petards in an Otherwise Safe Harbor-Part 2*, 33 EST. PLAN. 10, at 3 (Jun. 2006) (discussing some of the risks associated with the operation of GRATs, including the payment of the annuity).

351. Jonathan G. Blattmachr et al., *Drafting Administration for GRAT Performance*, PROB. & PROP., Nov. 2006, at 1.

352. *Id.*

353. *Id.*

354. *Id.*

355. *Id.*

acquiring life insurance to cover the period of risk. Also, an extended term may increase the risk that the GRAT will fail due to a decline in the value of the assets or because of volatile shifts in asset values from year to year.[356]

Even with the use of the countering techniques mentioned above, in many instances even an extended term will not enable the annuity to be paid solely with current and accumulated cash flow for the entire term of the GRAT. With graduated GRATs, the problem becomes more acute as time passes because the amount of the annual annuity payment will continue to rise.

C. *Real Estate Illustration*[357]

The client owns several parcels of real estate, each having a 5% cash flow and a projected annual appreciation of 5%. Each parcel is worth $10 million. The valuation appraiser determines that a 40% valuation discount is appropriate. The client has three children. At the time of the transaction, the AFR is 5%.

First, the client will create either a single-member LLC or multiple single-member LLCs—one for each parcel of property. The purpose of multiple single-member LLCs is the added asset protection provided by the separate entities. For income tax purposes, a single-member LLC is considered a disregarded entity; for gift tax purposes it is a valid separate entity under state law, which can be structured to accommodate planning with transferrable, discountable interests.[358]

Once the entities are created and the parcels are transferred to the entities, the client will transfer non-controlling interests in each LLC to three separate GRATs—one for each child. In this example, the client will transfer one-third of each LLC to each GRAT. If desired, the client can retain a 1% controlling interest in each LLC. To help cash flow in the earlier years, the design of the GRATs should be graduated GRATs with annuity payments increasing by 20% per annum as authorized by Treas. Reg. § 25.2702-3(b)(1)(ii)(A).[359]

In the later years of the transaction when the GRATs' cash flows are insufficient to pay the annuities, the grantor may choose to purchase assets directly from the disregarded entities for their fair market value as determined

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356. There are many discussions regarding how to counter other GRAT issues such as weak cash flow, volatility, and morality risks. *See* Mark R. Parthemer, *Enhance GRATs, Grantor Trust Sales and Family Loans with Financial Engineering*, 44th HECKERLING INST. ON EST. PLAN., (2010); Jonathan G. Blattmachr, et al., *Drafting Administration for GRAT Performance*, PROB. AND PROP., Nov. 2006, at 1; Richard A. Oshins, *Advanced Planning Strategies Using Grantor Trusts,* N.Y.U., 60TH INST. ON FED. TAX'N ¶ 27 (2002); Carlyn S. McCaffrey, et al., *Planning with GRATs,* N.Y.U. 62ND INST. OF FED. TAX'N (2004); Robert G. Alexander, *Enhancing the Planning Value of GRATs—Part I,* J. OF PRAC. EST. PLAN., Nov./Dec. 2008; Alexander, *supra* note 349.

357. *See infra* Exh. E.

358. Treas. Reg. § 301.7701-3(b) (2006).

359. *See infra* Exh. F (illustrating that with a level GRAT, the cash flow is unable to fully fund the annuity); Exh. G, (showing that with a graduated GRAT, the annuities can be funded during the initial few years).

by a qualified independent appraiser.[360] After the sales of their assets, the disregarded entities will have cash available to distribute to the GRATs which then will enable the GRATs to fund the annuity payments.[361] When purchasing an asset from the entities, the client should purchase the property in its entirety to avoid the application of valuation discounts to the purchased assets because the client would be purchasing fractional interests in the assets.[362] Also, if the client purchases the LLC's interests themselves, the purchase price will be subject to a valuation discount—a very undesirable result.[363] By acquiring the asset directly from the entity itself, a discount will not apply to the transaction because the entire asset, the whole parcel of real estate, is purchased.[364] Therefore, the client achieves the preferred goal of gifting discountable assets to the GRATs and receiving back cash, without a discount, in payment of the annuities. Furthermore, because the entities are disregarded entities and the GRATs are grantor trusts, the transactions are income tax-free.[365] As a final planning point, keep in mind that when implementing the graduated GRAT/discounted entity strategy, it is critical to ensure that the advisor properly designs and implements the entity, and that the client follows proper procedures with respect to administrating the GRAT, otherwise the IRS very likely will disqualify the GRAT with disastrous tax consequences to the client.[366]

In this illustration, the client gifts one-third interests in three entities into three ten-year GRATs. If the economic projections are accurate, the client will acquire, without discount, one property from an LLC, which in turn will distribute one-third of the proceeds it receives from the sale to each GRAT, solving the cash flow problem.

D. The Publicly Traded Securities Illustration

There appears to be specific authorization in the IRC to create a partnership for investment purposes, for example, by acquiring and managing a portfolio of securities.[367] Conventional wealth planning with publicly traded stocks usually involves a single asset, two-year rolling GRAT; however, a longer term, graduated GRAT funded with non-controlling interests in a disregarded entity may be significantly superior to the conventional short-term

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360. *See* Alexander, *supra* note 349, at 199.

361. *Id.*

362. JOHN A. BOGDANSKI, FEDERAL TAX VALUATIONS, Ch. 5 (Warren Gorham & Lamont, 1999).

363. *Id.* at Ch. 4.

364. *Id.*

365. Robert T. Danforth, *A Proposal for Integrating the Income and Transfer Taxation of Trusts,* 18 VA. TAX. REV. (1999) (discussing that GRAT is a grantor trust that would appreciate income tax free).

366. *See* S. Stacy Eastland, *Defending the Family Limited Partnership—Estate of Elaine Smith White v. Comm. in the Tax Court*, CCH Financial and Estate Planning, ¶ 31,961.

367. I.R.C. § 761(a). Attorney Richard A. Oshins presented this concept with Attorney John Porter where Porters' portion of the presentation substantially consisted of addressing the suitability of a discount in this context.

rolling GRAT approach.[368] In the authors' opinion, conventional rolling GRATs are not always an efficient planning technique because they do as follows: (1) allow for funding with discountable assets; (2) lock in present low interest rates; (3) enable the grantor to fully exploit the very low early payment feature of a graduated GRAT; (4) take advantage of the disregarded entity concept; or (5) lock in the strategy, protecting against a possible change in the law.[369]

VIII. IDGTS WITH DISREGARDED ENTITIES

A. Introduction

Similar to a GRAT, an ideal IDGT structure involves a grantor transferring discountable, income-producing assets into the IDGT in return for an installment note with interest-only payments for a period of time, and a balloon payment of principal at the end of the term.[370] It is preferable to make the interest and balloon payments with cash or other assets that are not subject to valuation discounts; however, this is difficult to achieve with assets that produce little or no cash flow.[371]

B. Illustration of the Strategy

Assume that the client has three children and owns real estate in a single member LLC with a 1.5% cash flow and projected appreciation of 5%. The real estate is worth $10 million and the appraiser determines that a 40% valuation discount is appropriate. The client could gift $300,000 of cash or cash equivalents to each of three IDGTs created for each of the client's three children and their descendants; preferably the IDGT's will be three separate generation-skipping dynasty trusts. The client would then sell one-third of the LLC to each of the three IDGTs for three installment notes paying interest only, plus a balloon payment of principal. Normally the notes in these types of transactions have nine-year terms, although the term can be shorter or longer depending on the needs of the specific client.[372] The installment interest rate is applied against the fair market value of each discounted interest transferred.[373] If the interest rate on the note is 4% per annum, annual interest payments of $80,000 per trust are payable to the client (4% x $2 million) for a total of $240,000 per year. The current cash flow in the entity is 1.5% of $10 million

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368. *See* Peter J. Melcher, *Are Short-term GRATs Really Better Than Long-term GRATs?*, 36 EST. PLAN. 3 (Mar. 2009).

369. *Id.*

370. Ann Berger Lesk et al., *Estate Planning with Real Estate Assets,* 603 PRAC. L. INST. 541, 555 (2004).

371. *Id.*

372. Mark S. Poker, *Sales to Intentionally Defective Grantor Trusts*, SN070 A.L.I.-A.B.A. 197 (2008).

373. *Id.*

or $150,000. Cash flow to each trust is based on the proportionate ownership of the entity and is not discounted.[374] Even though there is a projected, combined cash flow shortage of $90,000 each year, in addition to each IDGT's $50,000 of current cash flow, each IDGT will have $300,000 of seed money that can be used to pay the interest due as required by the note.

C. Discussion of the Strategy as Illustrated

Because interest payments are expected to exceed annual cash flow, the amount of the balloon payments when they become due may exceed the IDGTs' then annual and accumulated cash flow, and there possibly will be other needs for the cash flow (such as for additional construction, repairs or real estate taxes), the IDGTs face the dilemma of insufficient cash or cash equivalents to make the note payment(s).[375] In anticipation of this situation, one planning option is to make the payments in-kind.[376] These payments will be income tax-free.[377] However, appropriate valuation discounts will have to be taken for assets paid in-kind which will leak wealth from the trusts back to the grantor and adversely affect both the wealth transfer and asset protection built into the trust.[378] Alternatively, when the available cash in each IDGT is insufficient to pay its debt obligations (income or principal), the client can purchase the underlying asset directly from the entity, the LLC, for its appraised fair market value.[379] Remember, when acquiring the asset from the LLC, the client will acquire the entire interest in the asset; if the client only acquires a part of the asset, the fractional interest purchased will be subject to valuation discounts.[380] The acquisition of the 100% interest in the asset directly from the LLC will avoid the necessity of making note payments with discounted assets, in effect leaving in each of the trusts the original pre-discounted value of the assets (the full, fair market value of the assets) plus all of the post-transfer appreciation of the trust assets.[381] Thus, both the post-transfer appreciation of the assets and the discounts are shifted to the IDGTs. There is no gain on the purchase of the asset from the LLC because it is a disregarded entity for income tax purposes. In combination with Revenue Ruling 85-13 regarding sales to income tax defective trusts, the existence of the LLC essentially is ignored for income tax purposes.[382]

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374. *Id.*
375. *See* Alexander, *supra* note 349, at 199.
376. *Id.*
377. *See* Rev. Rul. 85-13 1985-1 C.B. 184.
378. Steve R. Akers, *GRATs, Installment Sales to Grantor Trusts; Designing Grantor Trusts; Defined Value Clauses, Summaries of Recent Family Limited Partnership Cases,* SH005 A.L.I.-A.B.A. 981 (2002).
379. *See* BOGDANSKI, *supra* note 362.
380. *See id.*
381. *See id.*
382. *See* Rev. Rul. 85-13, 1985-1 C.B. 184.

IX. THE "DOUBLE LLC" STRATEGY[383]

A. Basic Structure of an Installment Sale to an IDGT

An installment sale to an IDGT in exchange for a promissory note is a very popular wealth transfer strategy that offers many significant benefits. Generally, this technique is used to sell non-controlling interests in entities such as FLPs, FLLCs, and S-Corporations to income tax defective dynastic trusts (generally an IDGT or a BDIT), taking advantage of appropriate valuation discounts.[384] The trust is set up as a grantor trust for income tax purposes by intentionally violating one or more of the income tax grantor trust rules (an IDGT).[385] Typically, the note is structured as interest-only for a period of time with a balloon payment of principal at the end of the term and a right of prepayment without penalty.[386] The trust should be seeded with sufficient assets to sustain treatment of the technique as a sale, avoiding the risk that the transaction will be recast by the IRS as a transfer with a retained interest resulting in estate tax inclusion.[387]

B. Undercapitalization Risk

If the debt-to-equity ratio of the IDGT is too high, the IRS could attempt to recharacterize the sale to the IDGT as a gift (or partial gift) with a retained income interest, exposing the transaction to estate taxation pursuant to IRC Section 2036.[388] In order to avoid a "form-over-substance" or a "sham transaction" argument by the IRS in an attempt to undo the transaction for tax purposes, conservative planners believe that the IDGT should be funded independently with seed money.[389] It appears from most wealth planning commentators that the rule of thumb most practitioners use as the amount of seed money necessary to support the integrity of an installment note sale is 10% of the amount of the transaction.[390] This 10% rule of thumb is based upon an informal conversation noted wealth planning expert Byrle Abbin had with

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383. Richard A. Oshins, *Estate Planning with Disregarded Entities*, 44th National Association of Estate Planners and Councils Annual Conference 2009 [hereinafter Oshins, *Estate Planning with Disregarded Entities*].

384. *See* Poker, *supra* note 372, at 197; s*ee also* Alexander, *supra* note 349, at 199.

385. I.R.C. §§ 671-679 (West 2009).

386. *See* Lest et al., *supra* note 370, at 555.

387. I.R.C. § 2036 (West 2009).

388. *Id*.

389. *See* Akers, *infra* note 390; *see also* Zaritsky *infra* note 390.

390. S*ee* McDermott v. Comm'r, 13 T.C. #468 (T.C. 1949); Baker Commodities, Inc. v. Comm'r, 48 T.C. 374, T.C. 1967, *aff'd* 24 AFTR 2d 69-5516 F.2d 519, 69-2 USTC ¶ 9589, cert. den. (Although admittedly an anomaly, a 700:1 debt-equity ratio has been deemed legitimate.). *See also* Steve R. Akers, *Transfer Planning, Including Use of GRATs, Installment Sales to Grantor Trusts, and Defined Value Clauses to Limit Gift Exposure*, Outline for ABA (Sept. 28, 2007) at 39; Howard Zaritsky, *Open Issues and Close Calls—Using Grantor Trusts in Modern Times*, 43 U. MIAMI INST. ON EST. PLAN. ¶ 3 (2009).

the IRS: "Informally, IRS has indicated that the trust should have assets equal to 10% of the purchase price to provide adequate security for payment of the acquisition obligation."[391] Abbin also commented that he understands the 10% rule of thumb really means a 9:1 debt-to-equity ratio, and not a 10:1 debt-to-equity ratio.[392]

C. The "Double LLC" Concept

In its simplest form the double LLC concept utilizes two LLC's in order to dramatically increase the amount of assets that can be transferred over time to an IDGT or BDIT while taking into account the 10% seed money rule of thumb.[393] Although initially this concept seems risky, each individual component is considered safe, acceptable planning.[394] Because of the initial impression of risk, this technique may not be appropriate for all clients and each client should be adequately informed of the possible risks of using this strategy.

D. Illustration of the Concept

Assume that an IDGT is seeded independently with $1 million of assets (other than interests in either LLC1 or LLC2): LLC1 holds $15 million of assets and LLC2 holds $50 million of assets. With a 40% valuation discount on the value of the LLC units, the IDGT could purchase a 99% (non-controlling) interest in LLC1 for just under $9 million without exceeding the 10% rule of thumb. The trust would pay $1 million as a down payment and would issue a promissory note for the remaining $8 million. After a sufficient period of time has passed, and to avoid any appearance of a "step-transaction," LLC1 could then purchase a 99% interest in LLC2 for about $33.3 million. Because LLC1 has $15 million in assets and no debt, it could purchase up to $135 million of property for a note, while remaining within the 10% rule of thumb. This strategy is illustrated in Exhibit H.[395]

For income tax purposes, there is only one owner of LLC1 since all of the interests are owned by either the grantor or the grantor trust (the IDGT).[396] Consequently, LLC1 is disregarded as an entity separate from the grantor for income tax purposes, and no taxable event will occur when LLC1 purchases

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391. Byrle M. Abbin, *[S]he Loves Me, [S]he Loves Me Not—Responding to Succession Planning Needs Through a Three-Dimensional Analysis of Considerations to be Applied in Selecting from the Cafeteria of Techniques,* 31 U. OF MIAMI INST. ON EST. PLAN., ¶13 at 13-9 (1997); *see also* I.R.S. Priv. Ltr. Rul. 953026 (May 1, 1995) (issued to Byrle Abbin as a result of that meeting).

392. *Id*.

393. *See* Oshins*, supra* note 383.

394. *Id*.

395. *See infra* Exh. H.

396. *See* Oshins, *Estate Planning with Disregarded Entities, supra* note 383.

LLC2 units from the grantor.[397] However, independent from the income tax issues, for both gift and estate tax purposes and for purposes of making sales, LLC1 should be treated as having two owners: the grantor and the grantor trust. For gift tax and sales purposes, the asset is valued by the value of what the donee/purchaser receives.[398] Therefore, LLC1 will *not* be a disregarded entity under IRC Section 7701 for gift tax purposes. As a result, the sale of LLC2 units to LLC1 will not be treated as a sale of LLC2 units to the grantor trust for gift tax purposes, and the equity in the trust will not be treated as exceeding the 10% rule of thumb. Finally, the sale of LLC2 units to LLC1 is as a bona fide sale, and LLC1's debt-to-equity ratio is considered as one of several factors in determining whether the note issued by LLC1 is debt or equity.

For the reasons stated in the previous paragraph, if the grantor dies owning units in an LLC that is wholly owned by the grantor and a grantor trust, the LLC is considered as having two owners for estate tax purposes.[399] Therefore, valuation discounts may apply in determining the estate tax value of the grantor's LLC units.[400] Additionally, the LLC will *not* be disregarded for purposes of the section 1040 basis adjustment even though basis is an income tax consequence.[401] This is because the basis is adjusted to the "value placed upon such property for purposes of the Federal estate tax."[402] Therefore, the estate beneficiary's basis in the grantor's LLC units will be adjusted to the discounted estate tax value of the LLC units.[403]

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397. *See* Rev. Rul. 2004-77, 2004-2 C.B. 119. A partnership was owned by a corporation and an LLC wholly-owned by the corporation. *Id.* Although there were two partners under local law, because one of those partners (the LLC) was a disregarded entity as to the other partner, the corporation was treated as holding all of the LLC's interests in the partnership. *Id.* As a result, the partnership had only one owner for federal tax purposes and the partnership was disregarded as an entity for federal tax purposes. *Id.*

398. *See* Rev. Rul. 2004-88, 2004-32 I.R.B. 165. The IRS recognized that despite non-recognition of an entity for federal income tax purposes, the entity exists for state law purposes and therefore has a meaningful legal impact on the owners' rights and economic interests. *Id.* The Service stated,

> Although the regulations under sections 301.7701-1 through 301.7701-3 provide that a disregarded entity is disregarded for all federal tax purposes, these regulations do not alter state law, which determines a partner's status as a general partner. . . . Although LLC is a disregarded entity for federal tax purposes, LLC remains a partner in P and is the sole general partner authorized to bind the partnership under state law.

Id.

399. *Id.*

400. *Id.*

401. *Id.*

402. Treas. Reg. § 1.1014-1(a).

403. *See id.*

X. QUALIFIED PERSONAL RESIDENCE TRUSTS ("QPRTS") AND ALTERNATIVE PLANNING SOLUTIONS-HOUSE GRATS AND HOUSE IDGTS[404]

A. General Discussion and Analysis

Although QPRTs are popular estate planning vehicles, the authors believe they are significantly over-used.[405] Similar to the planning strategies illustrated above, transferring interests in a disregarded entity that holds title to a residence into GRATs and/or IDGTs appears to be a superior wealth shifting technique.

With a QPRT, the grantor transfers his residence to a qualified trust.[406] Preferably the grantor will transfer undivided interests in the residence to separate QPRTs in order to obtain valuation discounts based upon the valuation of fractional interests.[407] The grantor retains two rights: (1) the right to use and occupy the residence for a specified term; and (2) a contingent reversionary interest if the grantor dies during the term.[408] Both the use of the residence for the term of the QPRT and the contingent reversionary interest are capable of valuation and reduce the value of the gift to the QPRT for gift tax purposes.[409] If the grantor survives the term of the QPRT, the residence will pass to the remainder beneficiaries without further gift tax consequences.[410]

Unfortunately, there are several negative features associated with the QPRT. If the grantor does not survive the term of the QPRT, the residence will be included in the grantor's estate.[411] Furthermore, there is a prohibition against reacquisition of the residence which interferes both with the client's desire to live in the residence after the term and with the client's desire to obtain a step-up in basis in the residence at the client's death.[412] There are also complex and rigid regulatory requirements in creating and administering a QPRT.[413]

Rather than using a QPRT, an alternative planning technique is to combine the use of a disregarded entity with either a "House GRAT" and/or a "House IDGT."[414]

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404. *See* Oshins*, supra* note 383.
405. The technical requirements for a QPRT are set forth in IRC § 2702 and Treas. Regs. § 2702-5.
406. *See* I.R.C. § 2702; *see also* Treas. Reg. § 25.2702-5.
407. *See id*.
408. *See id*.
409. *See id*.
410. *See* I.R.C. § 2702; *see also* Treas. Reg. § 25.2702-5.
411. *See* I.R.C. § 2702; *see also* Treas. Reg. § 25.2702-5.
412. *See* Treas. Reg. § 25.2702-5(c)(9).
413. *See* Treas. Reg. § 25.2702-5.
414. *See* Akers, *supra* note 390.

B. Illustration

The client transfers the client's residence into a disregarded entity such as an LLC. The client retains the controlling interest in the LLC. The client then transfers non-controlling interests in the LLC to GRATs, IDGTs, or a combination of both. In order to continue to live in the residence without a transfer tax consequence, the client must pay fair market rent to the entity. The amount of the rent will vary depending upon the location, the size, and the current fair market rental value of the residence. Payments of rent to the LLC can be distributed pro rata to the members of the LLC, and can fund the annuity payments for a GRAT and/or the interest payments for a note sale to an IDGT.[415] With respect to the IDGT, the interest payments, plus the seed money, will be available to pay interest on the note.[416] At such time as the available cash flow cannot pay the annuity or note, the client can acquire the residence directly from the LLC for the then appraised fair market value of the residence. This transaction will leave both the appreciation in the value of the residence over time and the discount applied to the value of the residence at the initial transfer in the GRAT or IDGT.[417] The disregarded entity enables the client to reacquire the residence, an impermissible act in a QPRT, so that later the client may own and use the residence rent-free.[418] Additionally, upon the client's death, the property will receive a step-up in basis to fair market value as of the date of death.[419]

C. Comparative Illustrations

Assumed Facts: client, age 60, owns a residence worth $2 million. A reasonable valuation discount for an LLC or similar entity would be 30%.[420] The fair market annual rental will be 3%, the anticipated growth in the value of the residence is 2% per year, and the IRC section 7520 rate is 3.4%. Client A has three options: to transfer the residence to a QPRT, a GRAT, or an IDGT.

(1) If the client transfers the residence to a QPRT with a 15-year term, the client will have made a taxable gift of $599,172.00. In order for the QPRT to accomplish an effective transfer of wealth, the client must survive the term of 15 years otherwise there will be estate tax inclusion. In addition, even if the client does survive the term, the client has no right

415. *See* Oshins, *supra* note 383.
416. *Id.*
417. *See id.*
418. *See id.*
419. *See id.*
420. Note that a non-controlling interest in an LLC or similar entity owning a residence generally will receive a larger discount than a fractional interest in the residence itself would receive.

to reacquire the house from the QPRT. Lastly, the ETIP rule generally precludes the use of a QPRT as a generation-skipping trust.

(2) If the client transfers the residence to a House GRAT with a 15-year term, the client will have made a gift of $5.01. Similar to the QPRT, in order to effectively transfer wealth the client must survive the GRAT term of 15 years to avoid estate tax inclusion. However, unlike the QPRT, the client has the right to reacquire the house from the GRAT for its fair market value. As with the QPRT, the ETIP rule generally precludes the use of the GRAT as a generation-skipping trust.

(3) If the client transfers the residence to a House IDGT, the client has made a taxable gift of $160,000 (the tax on the seed money gifted to the trust). However, the residence (and its future income tax-free growth) will immediately shift out of the client's estate. Generally, there is no risk of estate tax inclusion of the trust assets if the client dies during the time that the note is outstanding. Only the value of the outstanding installment note is included in the client's estate. Unlike the QPRT and the House GRAT, the client does not have to survive the term of the trust because the ETIP rule does not apply to this transaction. Additionally, the House IDGT gives the client the right to reacquire the house directly from the trust (or better yet, directly from a single member LLC owned by the trust), and the client has the ability to draft the IDGT as a generation-skipping trust in order to lock in the original discount and the future appreciation in the value of the asset for multiple generations.

D. QPRTs v. House GRATs and House IDGTs

There are several important differences to keep in mind when comparing the use of a QPRT with the use of either a House GRAT or a House IDGT. Each of these differences must be considered carefully when determining which technique is the most appropriate strategy in any particular situation.

First, there is a dramatic difference in the amount of unified credit (applicable exclusion amount—"AEA") that is used in each situation.[421] Whereas QPRTs can use substantial amounts of unified credit, "zeroed-out" GRATs can be structured to use an insignificant amount of unified credit.[422] Because the installment sale to an IDGT is for a note in an amount equal in value to the asset sold, installment note sales to IDGTs use no unified credit except for the amount initially gifted as seed money to fund the IDGT.[423]

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421. *See infra* notes 424-25 and accompanying text.

422. *See* Estate Valuation Freezing and Discounting: The Qualified Personal Residence Trust (QPRT), http://familyestate.com/main/freezing.html (last visited Mar. 21, 2010); Dennis I. Belcher, *Overview of Grantor Retained Annuity Trusts (GRATs)*, McGuire Woods LLP, 1, 15 (2009), *available at* http://www.mcguirewoods.com/lawyers/index/dennis_i_belcher.asp.

423. *See* Roth, *infra* note 443.

Second, the risk of estate tax inclusion upon the client's death must be considered. In order to reduce the gift attributable to a QPRT, a longer term must be used which increases the risk of the client dying during the term and consequent estate tax inclusion.[424] As opposed to the QPRT, the term of a GRAT can be compressed, depending upon the anticipated cash flow and exit strategy, if cash flow is insufficient to make future annuity payments.[425] This will mitigate the risk of the client dying during the term of the GRAT. There is no survivorship requirement for IDGTs; the instant the sale is made to the IDGT the discount and post-transfer appreciation of the asset are immediately removed from the grantor's estate.[426]

Third, unlike other liquid assets, clients typically have an attachment, other than financial, to their homes.[427] Unfortunately, the grantor of a QPRT is prohibited from reacquiring the residence contributed to the QPRT.[428] In contrast to a QPRT, the grantor of a House GRAT funded with a disregarded LLC can reacquire the residence directly from the disregarded LLC.[429] The grantor of a House IDGT also may directly reacquire the residence contributed to the disregarded LLC for equivalent value.[430] Importantly, the assurance that the client is allowed to reacquire ownership of the client's home from either a House GRAT or a House IDGT usually makes wealth transfer planning with a residence much more palatable to most clients.[431]

Fourth, one must consider the regulatory rules associated with each planning technique. Whereas QPRTs face strict regulatory requirements, GRATs are subject to less onerous regulatory requirements.[432] IDGTs do not have any regulatory requirements.[433]

Fifth, to make wealth planning with a residence worthwhile, it is necessary for the residence to be of significant value.[434] As a result of this high value, the use of a QPRT is problematic since either the amount of the taxable gift will be large or the QPRT's term will have to be lengthened in order to

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424. *See* Estate Valuation Freezing and Discounting: The Qualified Personal Residence Trust (QPRT), *available at* http://familyestate.com/main/freezinghtml#QPRT (last visited Mar. 21, 2010).

425. *See* Belcher, *supra* note 422.

426. *See* Roth, *infra* note 443.

427. *See* Alan L. Olsen, *Tax Strategies for the Wealthy: Qualified Personal Residence Trust (QPRT)*, *available at* http://www.groco.com/readingroom/tax_qprtstrategies.aspx (last visited Mar. 21, 2010).

428. *See Qualified Personal Residence Trust Outline*, *available at* http://www.bassing.com/qprtinfo.com (last visited Mar. 21 2010).

429. *See* ROBERT RICKETTS AND LARRY TUNNELL, PRACTICAL GUIDE TO PARTNERSHIPS AND LLCS, CCH (3rd ed. 2006).

430. *See id.*

431. *See id.*

432. *See generally*, I.R.C. § 2702 (2009) (listing the statutory requirements for both QPRTs and GRATs).

433. *See* Roth, *infra* note 443.

434. *See* Richard J. Mikuta, *Estate Planning with a Personal Residence,* THE TAX ADVISOR, Oct. 1, 1993, *available at* http://www.allbusiness.com/accounting_reporting/corporate-taxes/383933-1.html (last visited Mar. 21, 2010).

avoid the larger gift.[435] Lengthening the term then increases the risk of estate tax inclusion should the grantor die during the term of the QPRT.[436] Unlike the QPRT, the amount of the gift can be minimized by using a "zeroed-out" GRAT.[437] Similarly, the amount of the gift with a House IDGT is minimal; equaling only the amount of the seed money.[438]

Sixth, the ability to use a dynastic, generation-skipping trust may be important to a client. Because of the ETIP rules, QPRTs and GRATs are generally very ineffective generation-skipping techniques.[439] IDGTs are generally structured as dynastic generation-skipping trusts, and the ETIP rules do not apply.[440]

All of the factors set forth above demonstrate that in comparison, both the House GRAT and the House IDGIT, in combination with a disregarded entity, prove to be more effective wealth transfer strategies than QPRTs.

XI. THE INTENTIONALLY DEFECTIVE FLP/FLLC: AN ALTERNATIVE TO "TOGGLING" ON AND OFF GRANTOR TRUST INCOME TAX STATUS[441]

A. Introduction[442]

The Family Partnership rules will tax a donor/partner for income tax purposes differently from the FLP/FLLC rules for transfer tax purposes.[443] Interestingly, the grantor trust rules for income tax purposes also differ from the grantor trust rules for estate and gift tax purposes.[444] Consequently, significant tax benefits can derive from intentionally violating the Family Partnership rules for income tax purposes while at the same time satisfying the FLP/FLLC rules for wealth transfer tax purposes.[445] If properly structured, planners can combine both of these techniques with either an IDGT or BDIT without necessarily exposing the trust beneficiary to income tax under IRC Section 678 in any given calendar year.[446]

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435. *Id.*

436. *See* Olsen, *supra* note 427.

437. *See* Belcher*, supra* note 422.

438. *See* Roth, *infra* note 443.

439. *See* Myron Kove & James M. Kosakow, *Estate Planning Benefits with Layered GRATS,* Financial Services Journal Online (1997), *available at* http://www.fsonline.com/fsj/articles/120197kove (last visited Mar. 20, 2010).

440. *See* I.R.C. § 2632 (2001).

441. This strategy was suggested to and outlined for the authors by attorney Richard A. Oshins.

442. *See* RICKETTS & TUNNELL, *supra* note 429.

443. *See* Randall W. Roth, *The Intentional Use of Tax-Defective Trusts*, 26TH ANNUAL PHILLIP E. HECKERLING INS. ON EST. PLAN., ¶ 4 (1992).

444. *Id.*

445. *Id.*

446. *Id.*

B. Toggling Grantor Trust Income Tax Status

Because both IDIT's and BDIT's are grantor trusts for income tax purposes, it is possible that at some point the grantor's continued obligation to pay taxes on trust income may become overly burdensome.[447] Therefore, practitioners generally consider it advisable for the governing trust instrument to contain mechanisms for turning on and off grantor income tax status which will then cause the trust income to be taxed to the trust or to its beneficiaries pursuant to the normal DNI rules.[448]

In order to avoid any potential tax problems with the "toggling" technique, it is advisable that the person holding the power to toggle on and off grantor trust income tax status (the toggling power) should be an individual or entity other than the grantor or someone one who has a beneficial interest in the trust.[449] If the toggling power is held by the grantor or a related party, the power probably will cause the trust assets to be included in the grantor's estate pursuant to IRC section 2036.[450] Therefore, the individual holding the toggling power should be an independent third party, independent trust company, or a trust protector.[451] The independent person possessing or exercising the toggling power should not be subject to any adverse estate or income tax consequence as a result of either holding or exercising said power.[452]

Before grantor trust status is turned off, it may be advisable to pay off any installment notes issued by the IDIT or BDIT to the grantor in an installment sale transaction.[453] The note should be paid in-kind if there is not sufficient cash to satisfy the note.[454] Since the trust will continue to be a grantor trust when the note is paid, gain, if any, will not be recognized on the payment even if appreciated assets are used to pay off the note.[455] If the installment note is not paid off in full before grantor trust status is turned off and the note was issued by the IDIT or BDIT to purchase marketable securities, any gain will likely be recognized immediately because installment sale treatment is not available for purchases of marketable securities.[456] Even if installment sale treatment is available because the sale does not involve marketable securities, after grantor trust status is turned off, interest payments will be taxable to the

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447. Oshins et al., *supra* note 146.
448. *See* Zaritzky, *supra* note 390.
449. *Id*. at P304.1(c).
450. *Id*.
451. *Id*. at P304.1(d).
452. *See id*.; *see also* Steve R. Akers, Estate Planning: Current Developments and Hot Topics, (June 2009) (unpublished manuscript, on file with the author at Bessemer Trust N.A.).
453. *See* I.R.C. § 453 (2009).
454. *Id*.
455. *Id*.
456. I.R.C. § 453(K) (2009).

grantor pursuant to the normal DNI rules.[457] Finally, keep in mind that payments of insurance premiums also may cause a recognition of gain.[458]

C. Toggling Family Partnership Income Tax Status

An interesting alternative to toggling on and off grantor income tax status with respect to trusts is the strategy referred to as the "intentionally defective FLP/FLLC."[459] With respect to income tax defective trusts, the payment of income tax by the grantor on wealth transferred to the trust is the functional equivalent of a tax-free gift, and if the grantor pays the income tax with respect to income generated from assets gifted to a dynastic trust, this dramatically leverages the GST exemption and wealth transfer.[460] In similar fashion, if the donor/partner of an FLP/FLLC gifts FLP/FLLC interests to family members and the donor/partner does not receive reasonable compensation for the donor/partner's services to the FLP/FLLC, the donor/partner is taxed on the FLP/FLLC income which otherwise would be attributable to the donated FLP/FLLC interests.[461] Importantly, the donor/partner's payment of this income tax is not treated as a gift to the donee/partners.[462] The reason is that the IRC specifically characterizes this issue as the proper statutory allocation of income and the resulting income tax consequences.[463] Therefore, it is not a wealth transfer tax issue because there is no gift element in the transaction as a result of the applicable income tax provisions.[464] This can provide fantastic wealth shifting opportunities for families where both the parent/donor of the FLP/FLLC interests and the child/donee are affluent.

Also note that both the grantor income tax rules and the Family Partnership income tax rules are applied on a year-to-year basis.[465] Therefore, just as the grantor of a grantor trust can toggle on and off income tax status with respect to the trust from year-to-year, the donor/partner of an FLP/FLLC can toggle on and off the income tax treatment of the FLP/FLLC from year to year pursuant to the partnership income tax rules of IRC Section 704(e) simply by choosing whether or not to receive reasonable compensation in any given tax year.[466] As a final point of comparison, if the grantor of the trust is taxed

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457. I.R.C. § 453(L)(3)(A) (2009).

458. *See supra* Part V.H-J.

459. *Intentionally Defective Grantor Trust*, *IDGT*, TRUSTMAKERS, http://www.trustmakers.com/Offshore-Asset-Protection/intentionally-defective-grantor-trust.php.

460. *See* Hesch, *supra* note 146.

461. I.R.C. § 704(e) (2009).

462. *Id*.

463. *See id*.

464. *See* I.R.C. §§ 704(e)(2), 706(e) (2009).

465. *See generally* I.R.C. § 704 (2009) (mentioning the "taxable year" in various sections).

466. With respect to grantor trusts, there is a question as to whether toggling off income tax status creates an income-taxable event and whether toggling back on grantor income tax status also triggers an income-taxable event. *See* Zaritsky, *supra* note 390, at P301. Importantly, the intentionally defective FLP/FLLC strategy will avoid this result.

on the trust income, and the trust is also subject to IRC Section 678 treatment, income tax is triggered at the grantor's death, and the trust is then taxed under the normal DNI rules.[467] With an intentionally defective FLP/FLLC, at the death of the donor/partner, the beneficiary (who also could be the inheritor/beneficiary of a BDIT) is taxed on the FLP/FLLC income.[468]

D. The Family Partnership Income Tax Rules[469]

Prior to becoming a popular wealth planning vehicle, FLPs generally were used to shift income within the family from high income tax bracket family members to those in a lower bracket. Congress enacted the Family Partnership rules to prevent the shifting of income under an assignment of income theory in situations where capital is not a material income-producing factor of the FLP.[470] IRC Section 704(e) and Treas. Reg. Section 1.704(e)(1) proscribe many rules which must be met if the family partnership is to be recognized for federal income tax purposes.[471] However, keep in mind that the rules for partnership recognition for income tax purposes differ from the rules for transfer tax purposes.[472]

For federal income tax purposes, an FLP/FLLC may allocate a share of its profits to a partner who receives a capital interest in the FLP/FLLC by gift if partnership capital is a material income-producing factor; i.e., an investment partnership rather than a service partnership.[473] However, pursuant to IRC Section 704(e)(2), the donee's allocable share of the FLP/FLLC's profits must be determined after making an allowance for reasonable compensation for services rendered to the partnership by the donor, and may not be greater, as a proportion of the donated capital, than the donor's share of partnership income attributable to the donor's share of partnership capital.[474]

IRC Section 704(e) provides a statutory rule for family partnerships which follows two well-established principles of tax law: (1) income derived from property is taxed to the owner of the property; and (2) income derived from services is taxed to the person performing the services.[475] The family partnership provisions of IRC Section 704(e) are virtually the same as the amendments to the 1939 IRC enacted in 1951 to assure that a bona fide owner of a capital interest in a family partnership in which capital is an income-

467. *Id*. at P302.4.
468. *Id*.
469. *See* RICKETTS & TUNNELL, *supra* note 429, at ¶ 904.
470. I.R.C. § 704(e) (2009).
471. *Id*.; Treas. Reg. § 1.704-1(e)(1) (2008).
472. *See* Samuel Donaldson, Stanley M. Johanson's Estate Planning Workshop: Income Tax Aspects of Family Limited Partnerships and LLCs (Dec. 11, 2009), *available at* http://www.utcle.org/eLibrary/preview.php?asset_file_id=22942.
473. *See* I.R.C. § 704 (2009).
474. I.R.C. § 704(e)(2).
475. I.R.C. § 704(e).

producing factor is respected as such.[476] These rules state that a person shall be recognized as a partner for income tax purposes "if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person."[477] In addition, the rules state that in a partnership in which capital is a material income-producing factor, a donee/partner's distributive share of income under the partnership agreement shall be taxed to the donee/partner, "*except* to the extent that such share is determined *without allowance of reasonable compensation*" to the donor for his or her services to the partnership, and "to the extent that the portion of such share attributable to donated capital is proportionately greater" than the donor's share attributable to the donor's capital.[478] What constitutes reasonable compensation paid to the donor is a facts and circumstances question. For the purpose of these allocation provisions, an interest purchased from a member of the family is treated as a donated interest.[479]

As stated above, when capital is a material income-producing factor, the partnership's income must include a reasonable payment to the donor/partner as compensation for any services rendered for, or on behalf of, the partnership.[480] When the donor is a partner, the payment is characterized as an IRC section 707(a) or 707(c) payment, depending upon the criteria set forth in IRC section 704.[481] After the donor's reasonable compensation is taken into account, the partnership is free to allocate its remaining income in any manner with certain exceptions.[482] If the donor/partner does not receive reasonable compensation, the donor/partner will pay income tax on the income attributable to the FLP/FLLC interests the donor/partner has gifted to a donee/partner.[483] As a result of these rules, the donee/partner's individual wealth attributed to the gifted FLP/FLLC interests will continue to grow undiminished by the donee/partner's payment of income tax with respect to said FLP/FLLC interests.[484] The wealth shift to the donee/partner as a result of these rules is similar to the wealth shift that occurs in the context of an IDGT as a result of a grantor paying the income tax liability of the IDGT.[485] The donor/partner of the FLP/FLLC can toggle on and off this income tax treatment in any calendar year simply by determining whether or not to receive reasonable

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476. *See id*.

477. I.R.C. § 704(e)(1).

478. I.R.C. § 704(e)(1)-(2) (emphasis added).

479. For planning purposes, it may be prudent to make sure the Family Partnership is not "overpaying" the salary to the donor/partner in order to avoid risking IRC § 2036 estate tax inclusion as a transfer with a retained interest. *See* I.R.C. §§ 704, 2036.

480. I.R.C. § 704.

481. *Id*.

482. *Id*.

483. *Id*.

484. *See supra* Part V.F.

485. *See supra* Part V.F.

compensation.[486] If the donor/partner elects to receive reasonable compensation, FLP/FLLC income is allocated appropriately to the donee/partners.[487] This toggling technique is less complicated than toggling techniques used with grantor trusts because the partnership toggling technique avoids the complex planning issues discussed with respect to grantor trusts above.[488]

E. Planning Opportunities with the Family Partnership Income Tax Rules and Income Tax Defective Trusts

There are at least several planning opportunities with FLP/FLLC interests that are either held in an IDGT, which is a grantor trust as to the settlor of the IDGT, or held in a BDIT, which is a grantor trust as to the inheritor/beneficiary of the BDIT. Because both the FLP/FLLC and the trust can be income tax defective as to the donor/partner, there can potentially be significant income tax planning opportunities by toggling on and off the income tax treatment of either or both the IDGT/BDIT and the intentionally defective FLP/FLLC in any calendar year.[489] Note that for both state law and income tax purposes, FLP/FLLC agreements, within reason, can define and allocate what is income and what is principal, and make allocations between the various partner/members giving an additional income tax planning opportunity with respect to FLP/FLLC's held in trust.[490] Also, the managing partner/members can determine when and in what amounts distributions are made to the partner/members.[491] Similarly, within parameters set by state law, the trust agreement can define what constitutes principal and income.[492] Also, the trustee usually has discretionary authority (within reason) to define and allocate receipts received from an FLP/FLLC to principal or income.[493] Finally, in a well planned dynastic trust such as a BDIT, the trustee will have complete discretion as to when, to whom, and in what amounts distributions are made to the trust beneficiaries.[494] The authors believe that there are significant income tax and wealth shifting opportunities created by the interplay of these FLP/FLLC and trust drafting issues, and the applicable income and wealth transfer tax rules. Unfortunately, the complexities of these matters are beyond the scope of this article.[495]

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486. I.R.C. § 704.

487. *Id.*

488. *See supra* Part XI.B.

489. *See* Zaritsky, *supra* note 390, at ¶ 3.

490. *See* UPIA § 505(c) (2009); I.R.C. § 643 (1996).

491. *See* UPIA § 505(c); I.R.C. § 643.

492. *See* UPIA § 505(c); I.R.C. § 643.

493. *See* UPIA § 505(c); I.R.C. § 643.

494. *See* UPIA § 505(c); I.R.C. § 643.

495. For a detailed discussion of these issues, *see* Carol A. Cantrell, *Special Problems with Partnership Interests in Estate and Trust Administration*, AICAP Conference on Tax Strategies for the High-Income Individual, ¶ 19 (2008); Richard B. Robinson, *Exiting the Discount Entity: What Happens When Family*

XII. CONCLUSION

As illustrated by the planning opportunities discussed throughout this article, the wealth transfer and asset protection planning opportunities available to practitioners by combining income tax defective trusts (such as GRATs, IDGTs, and BDITs) with properly created, funded, and administered discountable FLP/FLLCs, and situsing these trusts and entities in jurisdictions with enhanced wealth transfer and asset protection laws is limited only by the sophisticated practitioner's imagination. As additional examples of the techniques illustrated throughout this article, consider the following advanced planning strategies utilizing grantor trusts in combination with discountable FLP/FLLCs:

> (1) wealth planning with recapitalizations and reorganizations of FLP/FLLCs;
> (2) post-mortem wealth planning with a "note freeze partnership", combining life insurance, FLP/FLLCs and typical testamentary trusts such as QTIPS;
> (3) strategies combining FLP/FLLC planning with charitable remainder trusts;
> (4) FLP/FLLCs used as leveraged buyouts with charitable lead annuity trusts;
> (5) leveraged reverse freezes utilizing preferred FLP/FLLC interests;
> (6) FLP/FLLC interests in the context of IRC section 2036(a)(2) structured to enable the client to remain in control of FLP/FLLC interests (especially FLP/FLLC interests held in a BDIT); and
> (7) combining cash value life insurance, the BDIT, and life insurance financing strategies utilizing FLP/FLLCs to create what is perhaps the best private retirement plan—the Cash Value BDIT.[496]

Keep in mind that all of the tools and techniques discussed throughout this article, including those listed above, will require sophisticated financial modeling both to ensure that the structure will have adequate cash flow to enable the strategy to succeed and to ensure the client's financial independence

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Members Want to Take Their Share and Run: Minimizing the Income Tax Costs, 30th ANNUAL NOTRE DAME TAX AND EST. PLAN. INST., ¶ 10 (2004); Robert G. Alexander, *Income Tax Issues With Respect to Partnership and LLC Interests Held In Trust—Selected Issues*, The Palm Beach Tax Inst., (Jan. 2009) (unpublished manuscript, on file with the author); Alan H. Baseman, et al., *Holding Partnerships & LLCS in Trust. The Rest of the Story: How to Determine Distributions of Income, Principal and Tax Attributes*, The Palm Beach Tax Institute (Feb. 2009) (unpublished manuscript, on file with the authors).

496. HOWARD M. ZARITSKY, *TAX PLANNING FOR FAMILY WEALTH TRANSFERS: ANALYSIS WITH FORMS*, (4th ed. Warren Gorham and Lamont 2009); Eastland, *supra* note 47, at 141; Robert G. Alexander & Michael W. Halloran, *The Cash Value Beneficiary Defective Inheritor's Trust (The "Cash value BDIT"): Creating a More Flexible and Comprehensive Wealth Accumulation and Retirement Plan*, NYU Review Of Employee Benefits and Executive Compensation ¶ 7 (2009).

throughout an extended lifetime. The proper blend of appropriate strategies utilizing grantor trusts; discountable, pass through entities such as FLP/FLLCs; financial modeling; and selection of the best applicable state law will create an effective, flexible, and comprehensive wealth transfer and asset protection plan that will satisfy the most sophisticated needs of the client and the client's family for many generations.

XIII. Exhibits

Exhibit A

Summary of the Nevada Restricted Limited Partnership Laws NRS 87A.235 and 88

The primary statutory provisions creating the Nevada Restricted LP laws read as follows:

1. "Restricted limited partnership" means a limited partnership organized and existing under this chapter that elects to include the optional provisions permitted by NRS 87A.235.

2. If the limited partnership has elected in its certificate of limited partnership to be a restricted limited partnership pursuant to NRS 87A.235, subject to the provisions of NRS 87A.425, and unless otherwise provided in the certificate of limited partnership, the limited partnership shall not make any distributions to its partners until 10 years after:

   a. The date of formation of the restricted limited partnership as long as the original certificate of limited partnership elected to be treated as a restricted limited partnership and as long as the limited partnership has remained a restricted limited partnership since the date of formation; or

   b. The effective date of the amendment to the certificate of limited partnership in which the limited partnership elected to be treated as a restricted limited partnership and as long as the limited partnership has remained a restricted limited partnership since the effective date of the amendment.

3. The provisions of this section apply as the default provisions of a restricted limited partnership to the extent the provisions of this section are inconsistent with or add to the other provisions of this chapter and to the extent not otherwise modified in the certificate of limited partnership of the restricted limited partnership.

4. If the limited partnership has elected in its certificate of limited partnership to be a restricted limited partnership pursuant to NRS 88.350, subject to the provisions of NRS 88.520, and unless otherwise provided in the certificate of limited partnership, the limited partnership shall not make any distributions to its partners with respect to their partnership interests until 10 years after;

> a. The date of formation of the restricted limited partnership as long as the original certificate of limited partnership elected to be treated as a restricted limited partnership and as long as the limited partnership has remained a restricted limited partnership since the effective date of the amendment.
>
> b. The effective date of the amendment to the certificate of limited partnership in which the limited partnership elected to be treated as a restricted limited partnership and as long as the limited partnership has remained a restricted limited partnership since the effective date of the amendment.

5. The provisions of this section apply as the default provisions of a restricted limited partnership to the extent the provisions of this section are inconsistent with or add to the other provisions of this chapter and to the extent not otherwise modified in the certificate of limited partnership of the restricted limited partnership.

Exhibit B

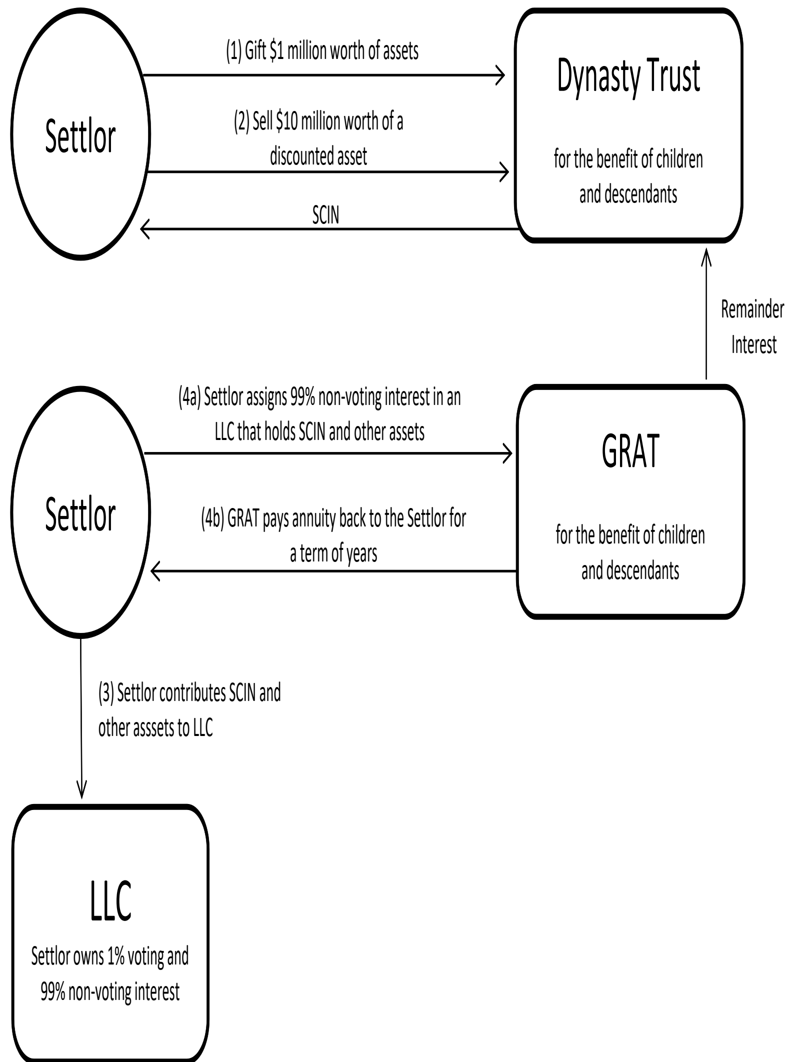


Exhibit C

Domestic Asset Protection Trust With Two (2) LLCs

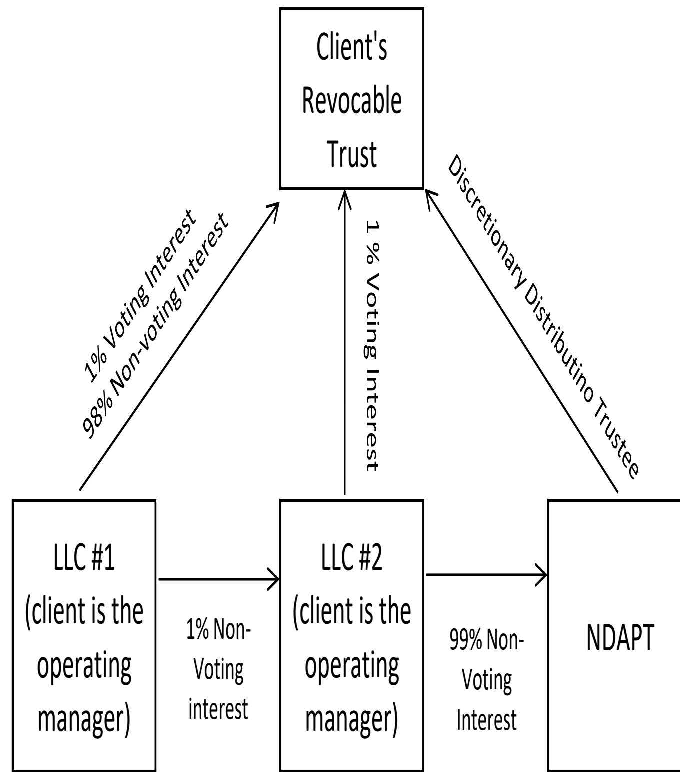


Exhibit D

Note Sale to a BDIT with a Guarantee

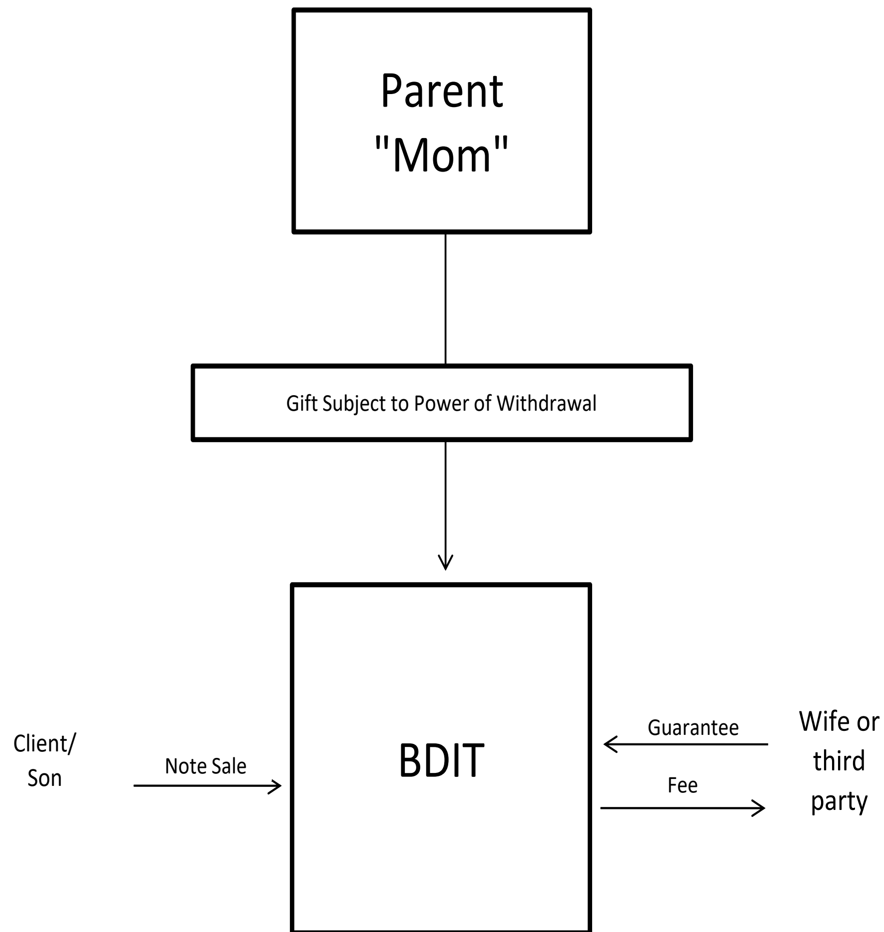
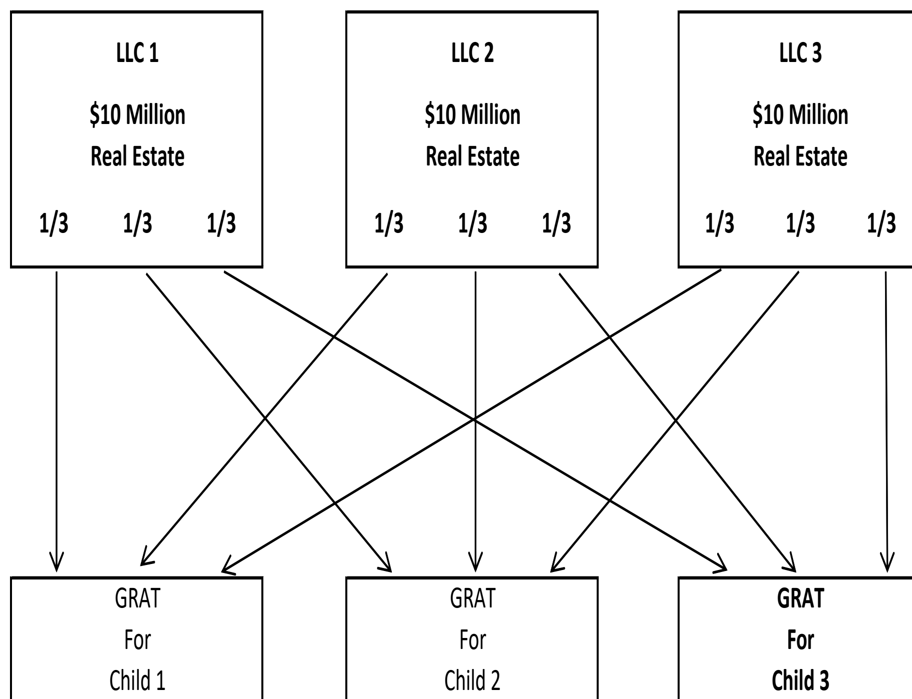


Exhibit E

GRAT with Disregarded Entity



This Exhibit was provided by Attorney Richard A. Oshins.

Exhibit F

LEVEL GRAT

Facts:

A typical client owning a business using a level GRAT with a 40% discount, cash flow is 5%, growth is 5%, §7520 rate is 5%.

Grantor Retained Annuity Trust	9/12/2005
Type of Calculation:	Term
Transfer Date:	9/2005
§7520 Rate:	5.00%
Grantor's Age(s):	
Income Earned by Trust:	5.00%
Term of Trust:	10
Total Number of Payments:	10
Annual Growth of Principal:	5.00%
Pre-discounted FMV:	$10,000,000
Discounted FMV:	$6,000,000
Percentage Payout:	12.95051%
Exhaustion Method:	IRS
Payment Period:	Annual
Payment Timing:	End
Vary Annuity Payments?	No
Is Transfer To or For the Benefit of a Member of the Transferor's Family?	Yes
Is Interest in Trust Retained by Transferor or Applicable Family Member?	Yes
With Reversion?	No

***** § 2702 IS Applicable *****

Base Term Certain Annuity Factor:	7.7217
Frequency Adjustment Factor:	1.0000
Annual annuity Payout:	$777,030.60
Initial Amount of Payment Per Period:	$777,030.60
Value of Term Certain Annuity Interest	$5,999,997.18
Value of Grantor's Retained Interest:	$5,999,997.18
(1) Taxable Gift (Based on Term Interest)	$2.82

This Exhibit was provided by Attorney Richard A. Oshins.

Exhibit F (cont.)

Economic Schedule
Principal value based on Pre-discounted FMV of contributed property

Year	Beginning Principal	5.00% Growth	5.00% Annual Income	Annual Payment	Remainder
1	$10,000,000.00	$500,000.00	$512,500.00	$777,030.60	$10,235,469.40
2	$10,235,469.40	$511,773.47	$524,567.81	$777,030.60	$10,494,780.08
3	$10,494,780.08	$524,739.00	$537,857.48	$777,030.60	$10,780,345.96
4	$10,780,345.96	$539,017.30	$552,492.73	$777,030.60	$11,094,825.39
5	$11,094,825.39	$554,741.27	$568,609.80	$777,030.60	$11,441,145.86
6	$11,441,145.86	$572,057.29	$586,358.73	$777,030.60	$11,822,531.97
7	$11,822,531.97	$591,126.56	$605,904.73	$777,030.60	$12,242,531.97
8	$12,242,531.28	$612,126.60	$627,429.76	$777,030.60	$12,705,057.73
9	$12,705,057.73	$635,252.89	$651,134.21	$777,030.60	$13,214,414.23
10	$13,214,414.23	$660,720.71	$677,238.73	$777,030.60	$13,775,343.07
Summary	$10,000,000.00	$5,701,555.09	$5,844,093.98	$7,770,306.00	$13,775,343.07

Exhibit G

GRADUATED GRAT

Facts:

A typical client owning a business using a graduated GRAT with a 40% discount, cash flow is 5%, growth is 5%, §7520 rate is 5%.

Grantor Retained Annuity Trust 9/12/2005

Type of Calculation:	Term
Transfer Date:	9/2005
§7520 Rate:	5.00%
Grantor's Age(s):	
Income Earned by Trust:	5.00%
Term of Trust:	10
Total Number of Payments:	10
Annual Growth of Principal:	5.00%
Pre-discounted FMV:	$10,000,000
Discounted FMV:	$6,000,000
Percentage Payout:	5.35492%
Exhaustion Method:	IRS
Payment Period:	Annual
Payment Timing:	End
Vary Annuity Payments?	Yes
Is Transfer To or For the Benefit of a Member of the Transferor's Family?	Yes
Is Interest in Trust Retained by Transferor or Applicable Family Member?	Yes
With Reversion?	No

***** § 2702 IS Applicable *****

Base Term Certain Annuity Factor:	18.6744
Frequency Adjustment Factor:	1.0000
Annual Annuity Payout:	$321,295.20
Initial Amount of Payment Per Period:	$321,295.20
Annual Annuity Payment Growth:	20.00%
Value of Term Certain Annuity Interest	$5,999,995.08
Value of Grantor's Retained Interest:	$5,999,995.08
(1) Taxable Gift (Based on Term Interest):	$4.92

This Exhibit was provided by Attorney Richard A. Oshins.

Exhibit G (cont.)

Economic Schedule
Principle value based on Pre-discounted FMV of contributed property

Year	Beginning Principal	5.00% Growth	5.00% Annual Income	Annual Payment	Remainder
1	$10,000,000.00	$500,000.00	$512,500.00	$321,295.20	$10,691,204.80
2	$10,691,204.80	$534,560.24	$547,924.25	$385,554.24	$11,388.135.05
3	$11,388,135.05	$569,406.75	$583,641.92	$462,665.09	$12,078,518.63
4	$12,078,518.63	$603,925.93	$619,024.08	$555,198.11	$12,746,270.53
5	$12,746,270.53	$637,313.53	$653,246.36	$666,237.73	$13,370,592.69
6	$13,370,592.69	$668,529.63	$685,242.88	$799,485.27	$13,924,879.93
7	$13,924,879.93	$696,244.00	$713,650.10	$959,382.33	$14,375,391.70
8	$14,375,391.70	$718,769.59	$736,738.82	$1,151,258.79	$14,679,641.32
9	$14,679,641.32	$733,982.07	$752,331.62	$1,381,510.55	$14,784,444.46
10	$14,784,444.46	$739,222.22	$757,702.78	$1,657,812.66	$14,623,556.80
Summary	$10,000,000.00	$6,401,953.96	$6,562,002.81	$8,340,399.97	$14,623,556.80

Exhibit H

"Double LLC Strategy"

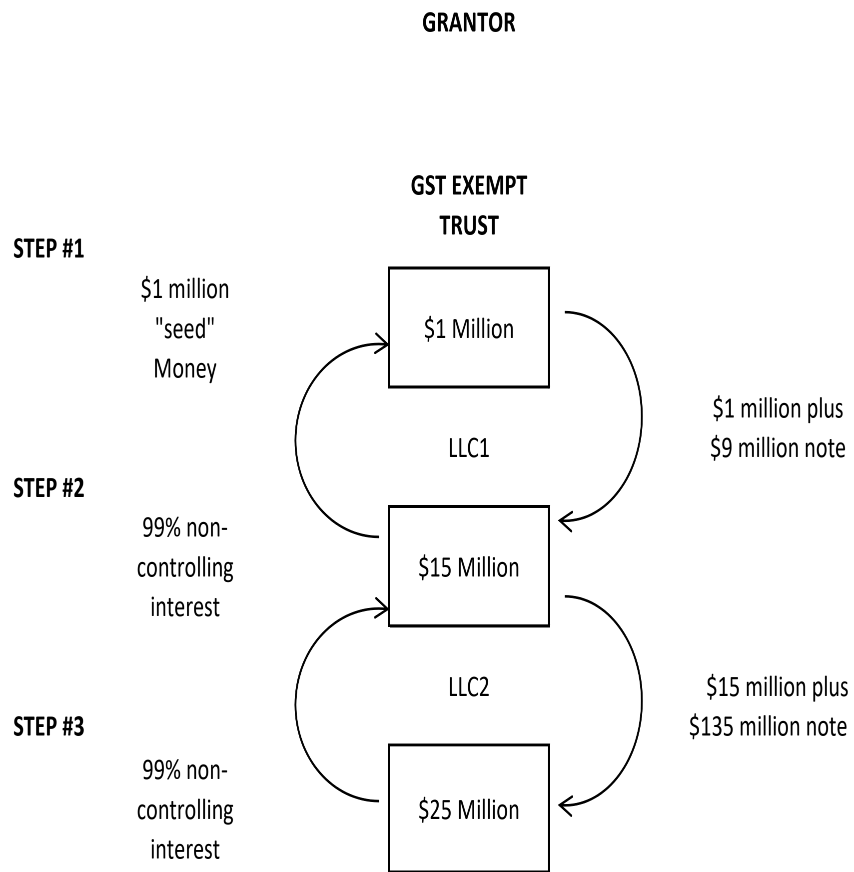


Exhibit I

Domestic Asset Protection Trust State Rankings

Rank	State	State Income Tax	Statute of Limitations (Future Creditor)	Statute of Limitations (Preexisting Creditor)	Spouse/Child Support Exception Creditors	Preexisting Torts/Other Exception Creditors	Comments
1	Nevada	No	2 Yrs.	2 Yrs. Or .5 Yr Discovery	No	No	Top of Tier 1
2	Alaska	No	4 Yrs.	4 Yrs. Or 1 Yr. Discovery	Divorcing Spouse	No	Tier 1
3	South Dakota	No	3 Yrs.	3 Yrs. Or 1 Yr. Discovery	Divorcing Spouse; Alimony; Child Support	Preexisting Torts	Bottom of Tier 1
4	Delaware	No (except residents)	4 Yrs.	4 Yrs. Or 1 Yr. Discovery	Divorcing Spouse; Alimony; Child Support	Preexisting Torts	Bottom of Tier 1
5	Tennessee	No (except dividends / interest on residents)	4 Yrs.	4 Yrs. Or 1 Yr. Discovery	Divorcing Spouse; Alimony; Child Support	No	Tier 2 - Big drop-off from Tier 1
6	Rhode Island	No	4 Yrs.	4 Yrs. Or 1 Yr. Discovery	Divorcing Spouse; Alimony; Child Support	Preexisting Torts	Preexisting tort creditors puts behind Tennessee
7	New Hampshire	Yes (dividends/i nterest)	4 Yrs.	4 Yrs. Or 1 Yr. Discovery	Divorcing Spouse; Alimony; Child Support	Preexisting Torts	Bottom of Tier 2
8	Wyoming	No	4 Yrs.	4 Yrs. Or 1 Yr. Discovery	Child Support	Property listed on app. To obtain credit; Property received by fraudulent transfer	Exception creditor statute restricts usability
9	Utah	No (except Utah source income)	3 Yrs.	3 yrs. Or 1 yr. Discovery	Divorcing Spouse; Alimony; Child Support	Numerous	Too many exception creditors
10	Missouri	No (unless Missouri source)	4 Yrs.	4 Yrs. Or 1 Yr. Discovery	Alimony; Child Support	State/U.S. to extent state/federal law provides	Very limited provisions
11	Oklahoma	Yes	4 Yrs.	4 Yrs. Or 1 Yr. Discovery	Child Support	Protection limited to $1,000,000	Limited to $1,000,000
12	Colorado	Yes	4 Yrs.	4 Yrs. Or 1 Yr. Discovery	No	No	Question whether law works

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