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TITLE: Holding Private Company Interests in Trust

AUTHOR: Parthemer, Mark R.

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Holding Private Company Interests in Trust

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Mark R. Parthemer, Esq.
Palm Beach, FL
parthemer@bessemer.com
Associate Fiduciary Counsel

Topic – Private Company Interests in Trust

A. Why in Trust?

B. Unique Issue #1 – S Corporation Shares in Trust, When an ESBT Trumps a QSST

C. Unique Issue #2 – Control, or “Sure, I can give it away, but…”

D. Unique Issue #3 - Funding of GRATs – A Case for 500, and The Discount Whipsaw

Section A. Why In Trust?

"Son, you're old enough now to start taking responsibility for your own actions as well as mine."

Three Typical Reasons For Irrevocable Trust

- Tax Planning - remove asset from estate, or at least freeze value
- Incapable Beneficiary
- Protection from Outsiders, such as non-family and creditors

Private Company Interests

- Private Company, Owner-Managed or Closely-Held Entities
- Organized as:
  - LLCs
  - Limited Partnerships
  - C corporations
  - S corporations

Unique Issue #1 – S Corporation Shares in Trust, When an ESBT Trumps a QSST

5 Types of Trusts Can Be Qualified Shareholders:

1. Trusts with Grantor Status under 671 – 678
2. QSST (Qualified Subchapter S Trust)
3. ESBT (Electing Small Business Trust)
4. Testamentary or continuing grantor trusts (limited to 2 years)
5. Voting Trusts

Grantor Trusts

Qualifies if Trust is Grantor as to Income and Capital Gains

Deemed Owner is Grantor or Beneficiary with Right to Vest Assets in Himself

CAUTION: Potential 2036(b) Issue with Substitution Power under 675 (4)(C)

- Right to reacquire voting shares could be problematic.
- See PLR 200514002 (2042 life insurance)
- Consider using other grantor trust powers or non-voting shares

QSST Requirements

Beneficiaries may elect S status if:

(A) the terms of governing document require that

(i) during the life of the current income beneficiary, there shall be only 1 income beneficiary of the trust,

(ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary,

(iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and

(iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary, and

(B) all of the income (within the meaning of section 643(b)) is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States.

ESBT Requirements

Established in 1996, trust must three requirements for ESBT status:

1. All of the trust's beneficiaries must be individuals, estates or certain exempt organizations described in 170(c)2 - 5.

   A *beneficiary* is any person to whom a distribution of income or principal may be made during the tax year. Therefore, any person who could receive a distribution of income or principal will be counted as a shareholder for purposes of the 100-shareholder limit.

2. No interest in the trust may be acquired by purchase; these interests must be acquired by gift, bequest, etc. Deemed acquired by purchase if basis determined under IRC 1012 (i.e., has a cost basis). Trust can acquire S stock by purchase, including part-gift, part-sale transactions.

3. The Trust must elect to be an ESBT. Trusts exempt from tax and those with elections in effect under prior law are not eligible to be ESBT's. Hence, CRT's can not elect, but CLT's can.

QSST versus ESBT

Advantages:

QSST may have income tax benefit as all distributions from ESBT are taxed at highest trust tax rate.

ESBT may have three benefits:

1. The election is easier to make because made by trustee. In fact, testator can mandate trustee make election.

2. The ESBT is a more flexible trust for nontax reasons. First, current distributions of income (required for a QSST), may be retained (useful if beneficiary is incapable or to avoid accumulation in beneficiary's estate). Second, testator or donor may create a single trust benefiting multiple beneficiaries (e.g., a sprinkle or spray discretionary trust).

3. The ESBT has transfer tax advantage of not accumulating wealth in income beneficiary's estate. Example - sprinkle/spray credit shelter trust can have surviving spouse as permissible beneficiary, or child/skip person of a GST Exempt Trust, but no mandatory distributions unless true need.

ESBT May Be Preferable More Often Than Not

Examples:

1. S stock to go into credit shelter trust, but Spouse has own assets. Planning concern is to avoid accumulating more wealth in Spouse's estate.

2. Grandparent interested in GST planning, but wants to use S stock. What are the considerations?

3. Non-voting S shares to pass in trust for numerous family with disparate financial circumstances.

4. Trust for children owns shares in S corporation, which owns 1%GP interest in an FLP. The trust has FAI (fiduciary accounting income).

5. S shares in trust for cousins with a history of not always getting along.

Unique Issue #2 – Control, or "Sure I can give it away, but…"

- Nature of Entrepreneur
- Tension with Tax Code
- Tension with Prudent Investor Rule and Other Fiduciary Laws

IRC 2036

Client Chooses Independent Trustee, But Wants String

- Concern over tax rules, such as 2036 and 672(c)
- Concern about Trustee Liability

Client Thus Seeks Retained Control via Other Than Independent Trustee

Three Carve-outs from Independent Trustee

1. Delegation under Prudent Investor Act

- Proper delegation provides protection
  - Careful agreement which includes delegee's submission to jurisdiction of applicable court
  - Appropriate Oversight (state law specific). Typically includes:
    - Defining scope of outside manager's role
    - Regular review of activity to ensure on task
    - Notice or waiver of intent to delegate
- Attention to fees

2. Client Directed Outsourcing

- Duty to exercise reasonable care remains
- No protection under Prudent Investor

3. Directed Trusteeship

Directed Trusteeship Jurisdictions

- Examples are Delaware, Ohio and South Dakota.
- Directed Trustee is not liable when acting upon direction, except for willful misconduct.
- Appointed Advisor may be regarded as a limited purpose fiduciary.

Cautions on Directed Trusts

- Secure written acceptance of Advisor with effective date.
- With respect to directed matters, trustee should act only upon direction.
- If Advisor is deemed a fiduciary, then his or her residency may affect tax situs of Trust. See NY TSB-A-04 Nov. 12, 2004.

More Cautions

Governing instrument (or court order) should:

- Carefully delineate areas of authority.
- Where appropriate, provide protection to advisors from conflict of interest issues.
- Expressly designate administrative trustee as controlling custody of assets.
- Provide roadmap for allocation of fees.
- Empower Independent Trustee with right to make administrative amendments.

Unique Issue #3 – The Funding of GRATs - A Case for 500, and The Discount Whipsaw

GRAT Basics:

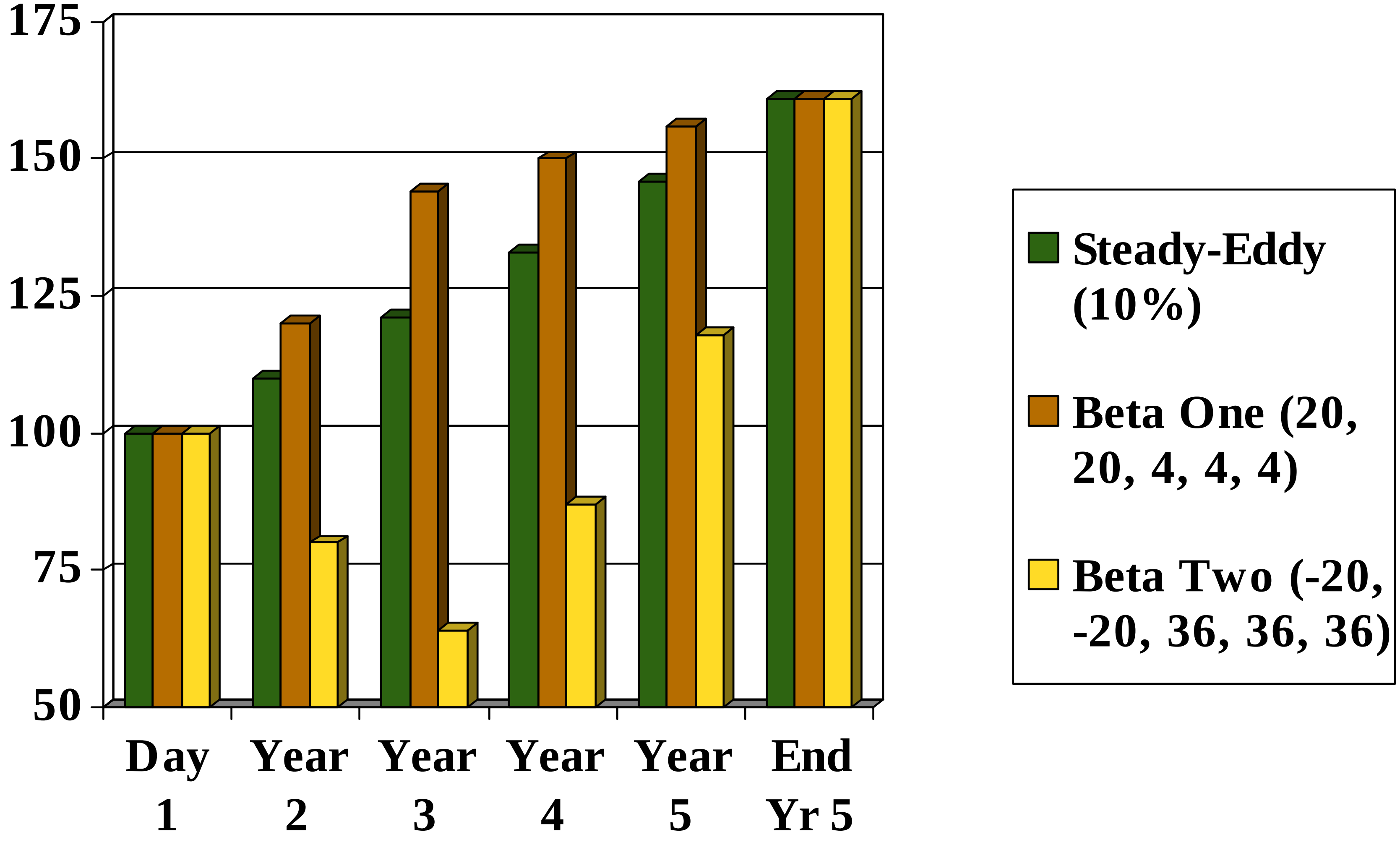
- A Grantor Retained Annuity Trust is an irrevocable trust for a set term during which an annuity is paid back to the grantor.
- Federal gift tax is assessed at time of creation, based on difference between funding value and value of annuity.
- GRAT can be structured to trigger little or no gift tax (“zeroed-out”) by using a high-enough annuity to offset the funding value.
- At end of term, all remaining assets pass estate and gift tax-free to beneficiaries.

The Great GRATsby – First of Three Ways to Make a Good GRAT Great

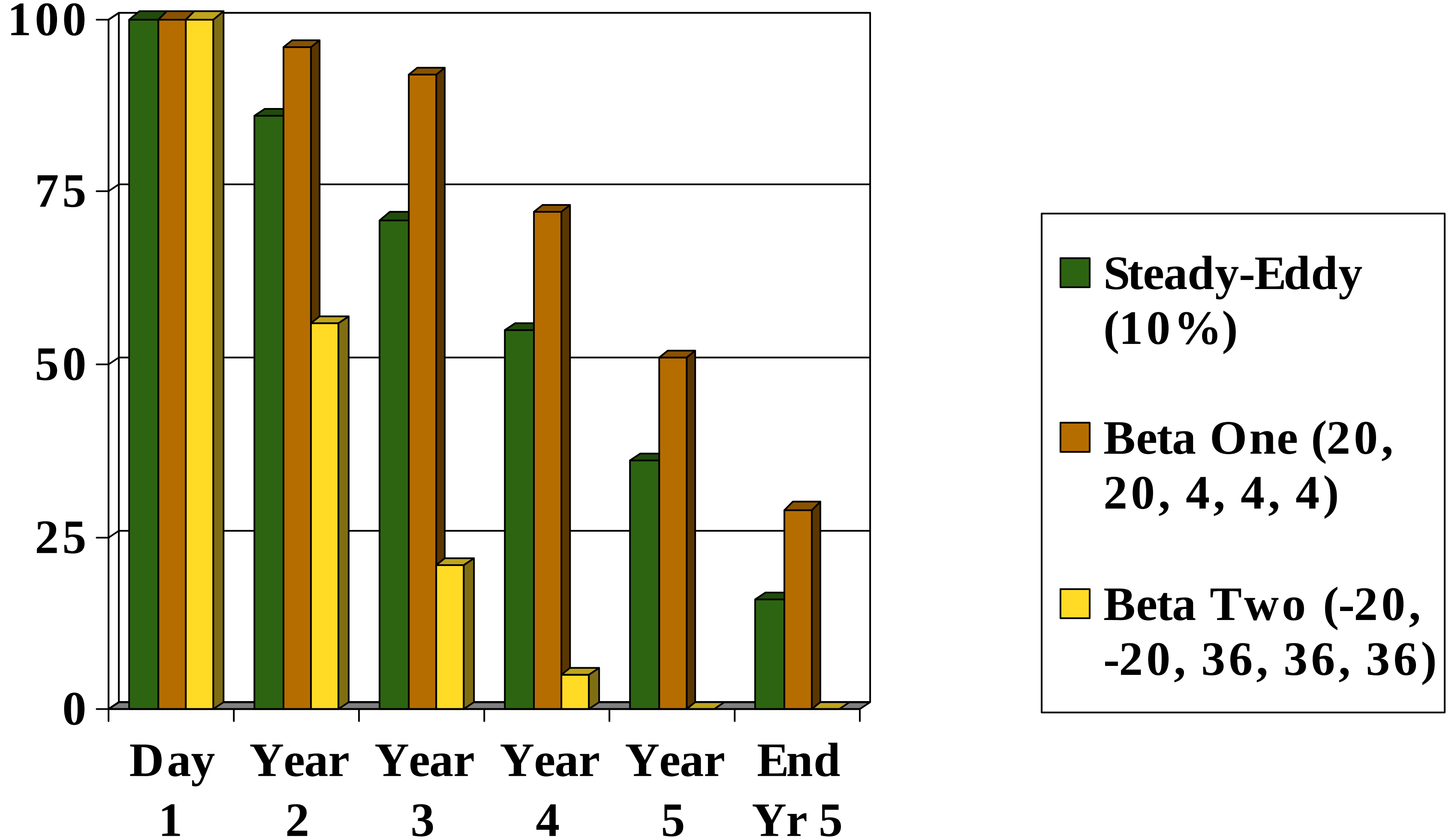
1. Structure - shorten the term and fund with the right assets

- Several scholarly articles have demonstrated that in many instances, a series of short term GRATs statistically will outperform one long term GRAT.
- For new GRATs, if remainder to fund a trust to which GST exemption will be allocated, consider GRAT term to expire in 2009.
- Three factors on structuring portfolio selection – risk, return and correlation.
- Why GRATs are different – seeking the "pop".
- A case for 500 2-year GRATs (or at least 11).

3 Sample Growth Patterns (in $10,000s)



Same Sample Growth Patterns with $1,000,000 Zeroed-Out GRAT Withdrawals of $237,394 (rounded)

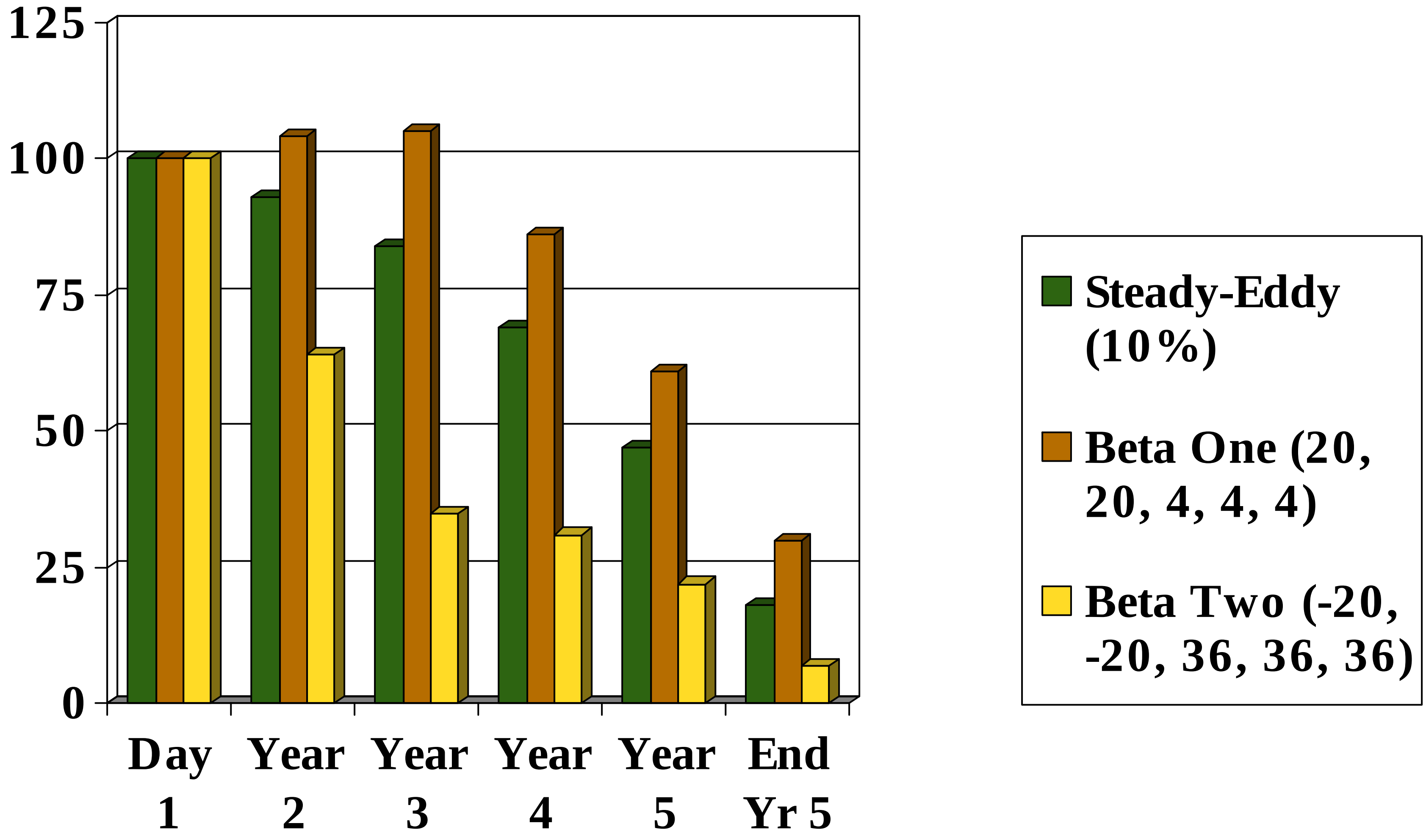


The Great GRATsby – Second of Three Ways to Make a Good GRAT Great

2. Increase the annual annuity

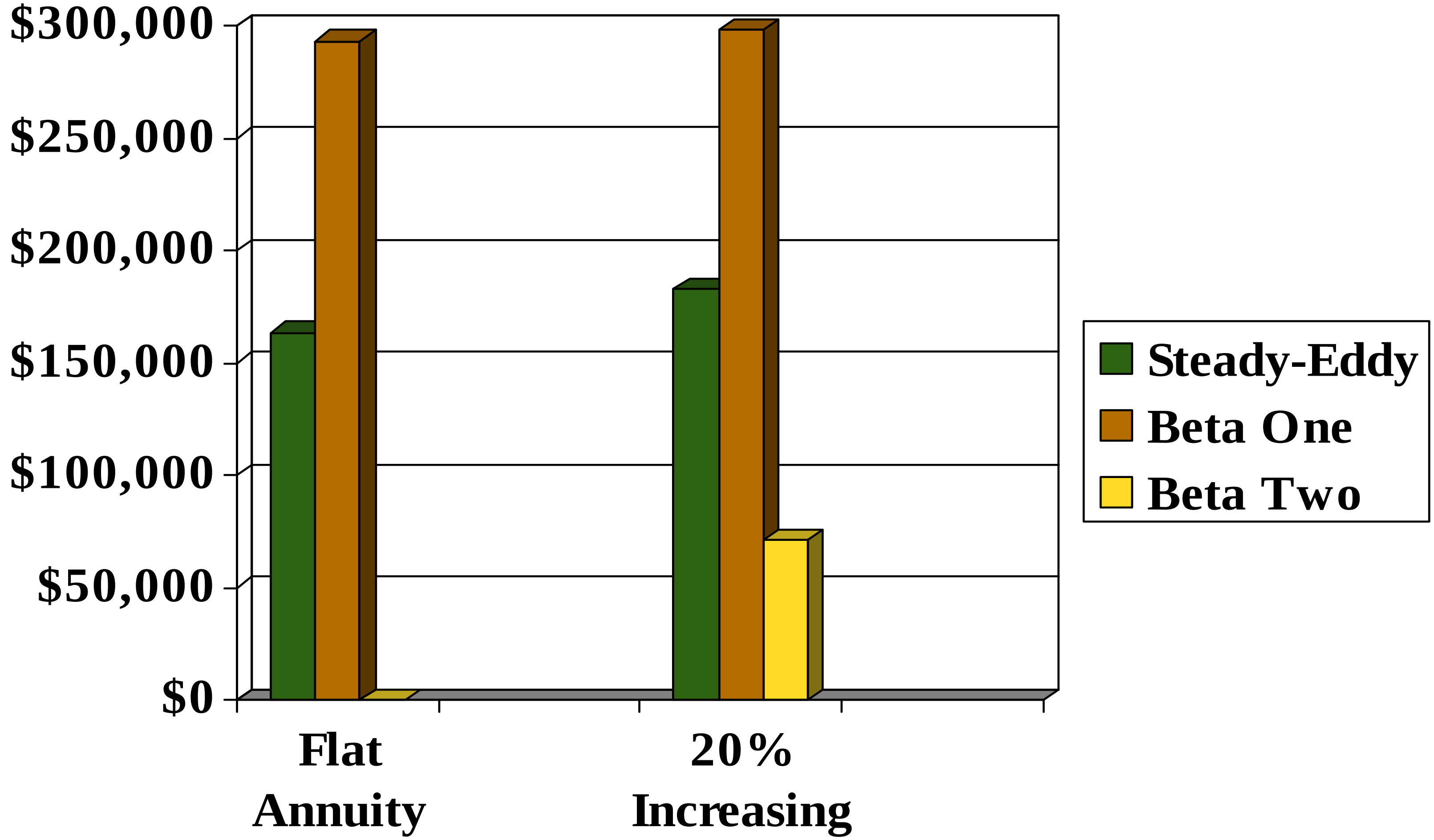
- Backload annuity distributions to allow assets maximum investment horizon to generate growth.
- Annuity payments can be increased up to 20% per year.

Same Sample Growth Patterns with $1,000,000 Zeroed-Out GRAT Withdrawals, 20% Increasing Annuity



Comparison of Flat versus Increasing Annuity

Final Results:



The Great GRATsby: Third of Three Ways to Make a Good GRAT Great - The Discount Whipsaw

3. Problem: Annuity paid with discounted asset.

- A private company interest, discounted asset, or an asset which has not yet blossomed may be inefficient to fund the annuity back to grantor,
- Or, proportionate distribution may be undesirable.
- Solution: Add marketable securities and/or a bond portfolio to be used for the annuity.
- Further, be intentional about the asset allocation of such portfolio assets – consider traditional view of RRC (risk, return, and correlation).
- **Solution:** Add portfolio assets at inception of GRAT with a well designed asset allocation to fund annuity payments.

Sample GRAT with LP Units and Portfolio Assets

Age of client in April 2006	65	Assumed yield of portfolio assets	5%
Terms of GRAT	5 years	Assumed LP units value in year 4	$17,500,000
Value of LP units ($5M pre 30% disc.)	$3,500,000	Assumed LP units value in year 5	$35,000,000
Value of portfolio assets	$10,000,000	Section 7520 Rate	5.6%
		Initial annuity to "zero out" GRAT (inc. 20%/yr)	$2,172,304

Year	Portfolio Assets Value	LP Units Value	Portfolio Augmented By Yield	Less Annuity Payment	Remaining Portfolio	Value of LP Units Distributed	% of LP Units Distributed	% of LP Units Remaining	Value of LP Units Remaining
1	$10,000,000	$3,500,000	$10,500,000	$2,172,304	$8,327,696	$0	0%	100%	$3,500,000
2	8,327,696	3,500,000	8,744,081	2,606,765	6,137,316	0	0	100	3,500,000
3	6,137,316	3,500,000	6,444,182	3,128,118	3,316,064	0	0	100	3,500,000
4	3,316,064	17,500,000	3,481,867	3,753,741	0	271,874	1.55	98.45	17,228,126
5	0	34,456,252	0	4,504,490	0	4,504,490	13.07	85.37	29,416,462

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