HOW TO GIVE AWAY THE FAMILY STORE –
LIFETIME TRANSFERS OF FAMILY BUSINESS INTERESTS

NEIL H. WEINBERG
Katten Muchin Rosenman LLP
525 W. Monroe Street, Suite 1900
Chicago, Illinois 60661
(312) 902 5646
neil.weinberg@kattenlaw.com

PAIGE K. BEN-YAACOV
Baker Botts L.L.P.
One Shell Plaza
910 Louisiana Street
Houston, Texas 77002
(713) 229-1474
paige.ben-yaacov@bakerbotts.com

HOW TO GIVE AWAY THE FAMILY STORE -
LIFETIME TRANSFERS OF
FAMILY BUSINESS INTERESTS

NEIL H. WEINBERG AND PAIGE K. BEN-YAACOV

I. Introduction.

A. Business Succession Planning for closely-held family businesses is more of an art than a science.

1. Must balance issues relating to control of the company with equity ownership and family dynamics.

2. Often times there is a constant struggle to attempt to create equality between family members who work in the business versus those who do not work in the business.

3. The business owner needs to develop strategies to attract and retain key non-family employees.

4. The business owner must face his own mortality and resolve to give up ownership and control over the business he/she helped create, or perpetuate, or both.

B. Once the final decision has been made to transfer the business to family members of the next generation, the business owner basically has two methods in which to make such transfers:

1. Gift it to them; or

2. Sell it to them.

II. Current State of Gift, Estate and Generation-Skipping Transfer Tax Laws (as of the date of this outline was written).

A. Federal Estate Tax

1. 2010: No estate tax on estates of decedents dying in 2010

2. 2011: $1 million estate tax exemption, indexed for inflation, and 55% top bracket

3. This outline assumes estate tax will be applicable for most clients.

B. Gift tax

1. 2010: $1 million exemption and 35% rate

2. 2011: $1 million exemption and 55% top bracket

3. Might consider making gifts of business interests this year to take advantage of lower tax rate, but beware possibility of retroactive legislation (possible changes -- rate changes, elimination of valuation discounts).

C. Generation-Skipping Transfer Tax

1. 2010: No exemption to allocate because exemption amount tied to estate tax applicable exclusion amount?

a. Perhaps not a problem for testamentary transfers to generation-skipping trusts because:

(i) Generation-Skipping Transfer occurs only if there is a transfer to an individual more than one generation below a “Transferor”;

(ii) the definition of “Transferor” is tied to a transfer subject to gift or estate tax; and

(iii) testamentary transfer in 2010 not subject to gift or estate tax.

b. Not a problem for Direct Skips (no generation-skipping transfer tax in 2010), but beware possibility of retroactive legislation.

c. Problem for transfers to generation-skipping trusts if taxable termination or taxable distributions will occur post-2010

2. 2011: Generation-Skipping Transfer Tax becomes applicable again.

a. $1 million exemption, indexed for inflation

b. Outline assumes ability to make inter vivos transfers to generation-skipping trusts.

D. State Gift, Estate and Generation-Skipping Transfer Tax Laws.

1. 2010: No State Death Tax Credit

2. 2011: State Death Tax Credit comes back

E. Other Issues on the Horizon:

1. Section 2704(b) Proposed Regs.?

2. 10 year requirement for GRATs?

III. <u>Lifetime Gifts</u>.

A. <u>Annual Exclusion Gifts</u>.

1. $13,000 per year per Donor/Donee

2. Small gifts do not normally justify transactional costs (appraisal fees, potential audit, etc.). Exception:

a. multiple annual exclusion gifts

b. could spread gifts over two years (*i.e.*, 12/31 of one year and 1/1 of the next).

3. Present interest requirement can make the use of other estate planning tools difficult (*e.g.*, defective generation-skipping trusts)

4. Annual exclusion may not be available at all, depending on terms of governing instruments. Three part test from *Hackl v. Commissioner*, 118 T.C. 279 (2002), *aff'd*, 335 F. 3d 664 (7th Cir. 2003) and *Price v. Commissioner*, T.C. Memo 2010-2:

a. entity will generate income at or near the time of the gifts;

b. some portion of that income would flow steadily to donees; and

c. the portion of income flowing to the donees can be readily ascertained.

B. Gifts Sheltered by the Gift Tax Exemption Amount.

1. Current gift tax exemption: $1,000,000 (thus, Husband and Wife could collectively give $2,000,000 without the imposition of any gift tax).

2. Any lifetime gifts sheltered by the gift tax exemption amount will reduce the amount available at death that may be transferred without the imposition of estate taxes.

3. Absent changes in the law for 2010, there will be no estate tax on the estates of decedents dying in 2010. Exemption amount for 2011 currently scheduled to be $1,000,000, indexed for inflation, but Congress may increase.

4. Potential advantage of making lifetime gifts of family business interests sheltered by gift tax exemption amount:

   a. All post-gift income and appreciation relating to such family business interests escapes transfer taxation

5. Potential disadvantage of making lifetime gifts of family business interests sheltered by gift tax exemption amount:

   a. Loss of step-up in basis for income tax purposes at death.

C. Gift Tax Statute of Limitations.

1. Under current law, the value of a gift is fixed for gift tax purposes if:

   a. The statute of limitations under Section 6501 of the Code has expired; and

   b. The value of the gift has been finally determined within the meaning of Section 2001(f)(2) of the Code.

2. This rule applies whether or not a gift tax is paid.

3. Under Section 2001(f)(2) of the Code, the value of a gift shall be treated as finally determined if:

   a. The value is shown on a return, or in a statement attached to such return, and such value is not contested by the IRS before the expiration of the statute of limitations with respect to such return;

(i) Finality is only achieved if gift was disclosed on the return, or in a statement attached to the return, in a manner adequate to inform the IRS of the nature of the item.

b. The value is determined by the IRS and such value is not timely contested by the taxpayer;

c. The value is determined by a court; or

d. The value is determined pursuant to a settlement agreement between the taxpayer and the IRS.

4. To determine whether the time has expired for assessing gift tax, the rules for adequate disclosure under Treas. Regs. Section 301.6501()c)-1(e), (f), control.

a. Treas. Reg. Sections 301.6501(c)-1(f)(1) allows gift taxes to be assessed at any time unless the transfer is adequately disclosed on a gift tax return or in a statement attached to the return.

b. Treas. Reg. Section 301.6501(c)-1(f)(2) requires that the following information be included in order for the transfer of property to have been adequately disclosed (other than a transfer of property valued under the rules of Section 2701 or Section 2702):

(i) A description of the transferred property, including any consideration received by the transferor.

(ii) The identity of, and the relationship between, the transferor and the transferee.

(iii) If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument;

(iv) A detailed description of the method used to determine the fair market value of the property transferred, including:

(a) any relevant financial data utilized in determining the value of the interest,

(b) any restrictions on the transferred property that were considered in determining the fair market value of the property;

(c) a description of any discounts claimed in valuing the property; and

(d) if the transfer consists of an interest in an entity that is not actively traded (e.g., a closely-held business), a description must be provided of any discount claimed in valuing the interests in the entity or any assets owned by such entity.

(v) A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer.

c. Treas. Reg. Section 301.6501(c)-1(f)(3) provides that the requirement to provide a detailed description of the method used to determine the fair market value of the property transferred will be satisfied if the donor submits an appraisal of the transferred property that satisfies the following requirements:

(i) The appraisal is prepared by an appraiser who satisfies all of the following requirements:

(a) The appraiser is an individual who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;

(b) Because of the appraiser's qualifications, as described in the appraisal that details the appraiser's background, experience, education, and membership, if any, in professional appraisal associations, the appraiser is qualified to make appraisals of the type of property being valued;

(c) The appraiser is not the donor or the donee of the property or a member of the family of the donor or donee, or any person employed by the donor, donee, or a member of the family of either;

(ii) The appraisal contains all of the following:

(a) The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal;

(b) A description of the property;

(c) A description of the appraisal process employed;

(d) A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analysis, opinions and conclusions;

(e) The information considered in determining the appraised value, including in the case of an ownership in a business, all financial data that was used in determining the value of the interest that is sufficiently detailed so that another person can replicate the process and arrive at the appraised value;

(f) The appraisal procedures followed and the reasoning that supports the analyses, opinions and conclusions;

(g) The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred; and

(h) The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

d. Treas. Reg. Section 301.6501(c)-1(f)(4) contains the requirements for disclosing transfers to family members that are not considered gifts.

(i) If a transfer is made in the ordinary course of operating a business, such as a salary payment, the transfer is adequately disclosed if all parties properly report the transaction on thier income tax returns.

(a) Such a transfer does not have to be reported on a gift tax return.

(b) However, be wary of deducting salary payments made to family members who do not actually perform services for business.

e. Treas. Reg. Section 301.6501(c)-1(f)(5) applies to incomplete gifts that are adequately disclosed.

f. The statute of limitations begins to run with respect to an adequately disclosed gift, even if the gift is later determined to be incomplete.

(i) Once statute of limitations has run, IRS cannot change the taxpayer's treatment of the gift and cannot bring the property back into the donor's gross estate for federal estate tax purposes.

(ii) If transfer is reported as an incomplete gift (whether or not adequately disclosed), the period of limitations for assessing a gift tax as to the transfer will not commence even if the transfer eventually is determined to be a completed gift.

(a) Instead, gift tax may be assessed at any time until three years after the donor files a gift tax return reporting the transfer as a completed gift with adequate disclosure.

(iii) Regulation encourages taxpayers to submit gift tax returns which disclose a non-taxable gift transaction (e.g., sales of family business interests for fair and adequate consideration) for the purpose of starting the statute of limitations with respect to the reported transaction.

5. Only gifts that are adequately disclosed are protected.

a. Should consider disclosing gifts which qualify for the gift tax annual exclusion in order to protect them from revaluation.

b. Note that if a gift tax return is required to be filed due to taxable gifts made in any year, any annual exclusion gifts made in that year also must be reported on gift tax return.

6. Rev. Proc. 2000-34, 2000-2 C.B. 186 - Adequately disclosing a gift on an amended gift tax return if donor filed a Form 709 in a year in which donor made a gift but failed to adequately disclose the gift.

a. Revenue procedure applies if:

(i) Donor did not report the gift on the return; or

(ii) Donor failed to submit with the return the information concerning the gift to adequately disclose the gift.

b. The period of limitations will generally expire three years after the date the amended return is filed.

c. Amended return must identify the gift and provide all of the information required under Treas. Reg. Section 301.6501(c)-1(f)(2) that the donor did not submit on the original gift tax return for the calendar year in which the undisclosed gift was transferred.

d. The donor must file the amended return with the same IRS Service Center where the donor filed the original gift tax return.

e. At the top of the first page of the amended return, the donor must place the words: "Amended Form 709 for gift(s) made in (insert calendar year gift was made) – In accordance with Rev. Proc. 2000-34, 2000 34 I.R.B. 186"

IV. <u>Outright Gifts of Interests in Closely-Held Family Businesses</u>.

A. <u>Non-Voting Stock</u>. Have company create a separate class of non-voting common stock. Subsequently, have Donor give away non-voting shares and retain the voting shares.

1. Separates voting control from equity ownership.

2. Lack of voting power may reduce the value of the shares.

3. Useful with S-Corporations.

4. Upon death of Donor, only the voting and non-voting shares retained by the Donor should be included in the Donor's estate. However, be aware of <u>Simplot v. Comm'r</u>. 112 T.C. No. 13.

B. <u>Buy-Sell Agreement</u>.

1. Owners of family businesses may wish to restrict transferability of family business interests.

2. Buy-sell agreement could restrict ability to transfers shares outside “permitted assignee” group.

3. “Permitted assignees” might be limited to include family members, charities, etc.

   a. Allow transfers to entities that are partially or wholly owned by permitted assignees? May wish to consider who has control of entity.

   b. Allow transfers to trusts for the benefit of permitted assignees?

      (i) May wish to put restrictions on identity of trustees.

      (ii) Need to allow for the fact that some non-permitted assignees may be contingent remainder beneficiaries.

   c. Allow transfers to trusts for the benefit of spouses of permitted assignees?

4. Complete prohibition on transfers does not work in situations such as death, divorce, or other involuntary transfers. Thus, consider giving some combination of company and family business owners option to purchase.

   a. If descendant’s spouse dies or in event of divorce, consider giving descendant first right to purchase if business interests otherwise would pass outside of permitted assignee group; if descendant does not purchase, some combination of company and other owners could be given right to purchase.

   b. Best to use fair market value as defined in Treas. Reg. § 25.2512-1 as purchase price in death situation.

c. In divorce situation, could consider limiting purchase price to book value.

d. Agreement can dictate terms under which stock would be purchased (date by which payment is due, installment sale, rate of interest, etc.).

5. Right of first refusal could be given to some combination of company and other owners if an owner wishes to make an inter vivos transfer outside of the permitted assignee group.

a. Purchase price could be lesser of:

(i) proposed transfer price to third party; or

(ii) fair market value as defined in Treas. Reg. § 25.2512-1.

b. Agreement can dictate terms under which stock would be purchased (date by which payment is due, installment sale, rate of interest, etc.).

C. Valuation of Interests in the Closely-Held Family Business.

1. General Rule. Fair market value is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy and sell and both having reasonable knowledge of the relevant facts.

2. Application to Closely-Held Family Business Interests.

a. A determination of the fair market value of an interest in a closely-held family business for purposes of gift taxes depends on the relevant facts and circumstances in each case.

b. Rev. Rul. 59-60, 1959-1 C.B. 237 sets forth the various factors to be considered in valuing interests in closely-held corporations for gift tax purposes:

(i) The nature of the business and the history of the enterprise from its inception;

(ii) The economic outlook in general and the condition and outlook of the specific industry in particular;

(iii) The book value of the stock and the financial condition of the business;

(iv) The earning capacity of the company;

(v) The dividend-paying capacity of the company;

(vi) Whether the enterprise has goodwill or other intangible value;

(vii) Sales of the stock and the size of the block of stock to be valued;

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

3. Valuation Penalties.

a. Penalty for Substantial Gift Tax Understatement.

(i) If the value reported on a return is 50% or less of the amount finally determined to be the correct value, then Section 6662 of the Code imposes an addition to tax of 20% of the resulting underpayment of gift tax attributable to such substantial valuation understatement.

(a) No penalty is imposed if the portion of the underpayment of tax attributable to the understatement if $5,000 or less.

b. Penalty for Gross Valuation Misstatement.

(i) If the value reported on a return is 25% or less of the amount finally determined to be the correct value, then the penalty under Section 6662 of the Code will be 40% of the amount of the underpayment of tax.

D. <u>Valuation Discounts</u>.

1. Lack of Marketability.

a. Typically, there is no readily available market for interests in closely-held businesses.

b. Since an interest in a closely-held business is more difficult to sell than publicly traded securities, a discount for this lack of marketability should be available.

c. This discount should be available for transfers of both minority and majority interests in a closely-held business.

2. Lack of Control - Minority Interests.

a. Absent a voting agreement, a shareholder who owns a minority interest in a closely held business cannot control corporate policies.

b. The inability to influence day-to-day management of the business, compel the payment of dividends or get at the assets of the business by liquidation should result in a valuation discount for a minority interest.

c. Even if the family as a whole will control the business both before and after a transfer, gifts of minority interests should still be entitled to valuation discounts for lack of control.

E. Aggregation At Death.

1. When valuing closely held stock for estate tax purposes, § 2044 of the Code does not require that stock held in a QTIP Marital trust for the decedent's benefit be aggregated with stock in the same company that is held by the decedent individually. Estate of Mellinger. 112 T.C. No. 4.

2. Under this scenario, each block of stock may be entitled to significant valuation discounts.

3. Consider splitting ownership between spouses. Estate planning documents should avoid leaving stock held by first to die to surviving spouse outright or in trust over which surviving spouse has general power of appointment.

F. Formulaic or Defined-Value Transfers.

1. Determining fair market value of closely-held interests is not an exact science. IRS has policy of auditing returns involving valuation

discounts. Formulaic or Defined-Value Transfers may help minimize unexpected transfer taxes.

2. *Comm’r v. Procter*, 142 F. 2d 824 (4th Cir. 1944). Donor reacquired property if transfer subject to gift tax.

   a. Condition subsequent -- void as against public policy.

   b. Trifling with judicial process; would inhibit tax collection.

3. *Ward v. Comm’r*, 87 T.C. 78 (1986). Donor reserved right to revoke gift if stock was worth more than $2,000/share.

   a. Void as against public policy under *Procter* analysis

   b. Other cases where Tax Court ignored adjustment clauses - *Harwood v. Comm’r*, 82 T.C. 239 (1984), *aff’d*, 786 F.2d 1174 (1986), and *Estate of McLendon v. Comm’r*, 66 T.C.M. (CCH) 946 (1993), *rev’d on other grounds*, 77 F.3d 477 (5th Cir. 1995).

4. *King v. United States*, 545 F.2d 700 (10th Cir. 1976). Consideration received by Donor automatically adjusted to fair market value of property transferred.

   a. 10th Circuit agreed with taxpayer that no gift was made because adjustment clause worked.

   b. Distinguishable from *Procter* -- no attempt to reconvey stock to Donor.

5. *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006). Inter Vivos defined-value transfer with charity lid.

   a. Partnership interests conveyed jointly to Donors’s sons, trusts for benefit of Donors’ descendants, and charities.

   b. Assignment agreement provided for sons and trusts to receive that portion of partnership interests equal to fixed dollar amount; charities to receive everything in excess.

   c. Donees independently negotiated portion of partnership interests that each received.

d. When partnership interests were determined to be worth more than value reported on gift tax return, Donors did not receive any portion of partnership interests back or receive any additional consideration from Donees. Increase to value of partnership interests also did not change allocation between Donees, but Donors were not parties to that allocation (recall independently negotiated by Donees).

e. IRS argued that defined-value transfer was void as against public policy (*Procter*). Tax Court found that value of gift should be value of partnership interests received by charities pursuant to agreement among Donees.

f. 5th Circuit reversed -- defined value clause upheld.

6. *Christiansen v. Commissioner*, 130 T.C. No. 1 (2008). Testamentary/disclaimer defined-value transfer with charity lid.

a. Will provided that disclaimed assets would pass 75% to CLAT and 25% to private foundation.

b. Beneficiary disclaimed all assets in excess of $6.35 million, as finally determined for federal estate tax purposes.

c. Increase in value of partnership interest in estate for federal estate tax purposes would increase portion of partnership interest passing to charitable beneficiaries, although no charitable deduction for portion passing to CLAT because that disclaimer was not a qualified disclaimer.

d. IRS argued *Procter*, but Tax Court upheld formula disclaimer, noting the following:

(i) distinction between post-death events that change actual value and post-death events that "are merely part of the legal or accounting process of determining value at the time of death"

(ii) "Commissioner's role is not merely to maximize tax receipts . . . Rather, the Commissioner's role is to enforce the tax laws."

(iii) No policy to maximize incentive for Commissioner to audit returns, but there is a clear policy of encouraging charitable gifts.

7. *Petter v. Commissioner*, T.C. Memo. 2009-820. Inter vivos defined-value transfer with charity lid based on values as finally determined for federal gift tax purposes.

   a. IRS argued *Procter*, but Tax Court upheld, citing to cases above, and again noting policy of encouraging charitable gifts

8. Defined-value transfer also can be accomplished in inter vivos transfers with use of GRAT lid.

V. <u>Grantor Retained Annuity Trusts ("GRATs")</u>.

A. <u>Overview of Technique</u>.

1. Owner of closely-held business (the "Grantor") transfers all or a portion of his interests in the business to an <u>irrevocable</u> trust which satisfies the requirements of § 2702 of the Code.

2. Under the terms of the GRAT, the Grantor retains the right to receive annual annuity payments for a designated period of years (the "GRAT Period").

3. If the Grantor survives the end of the GRAT Period, all assets remaining at the end of the GRAT Period will be transferred to the Grantor's children (or to trusts for their benefit).

   a. If the property transferred to the GRAT produces income greater than the § 7520 rate, then such excess value will pass to the remaindermen free of transfer tax.

4. If the Grantor dies before the end of the GRAT Period, then the transaction is unwound and generally treated for transfer tax purposes as though no transfer had been made in the first instance.

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

1. General Rule.

   a. A Grantor's gift to a GRAT is reduced by the present value of the annuity payments, computed using the § 7520 discount rate in effect at the time the gift is made, as long as the GRAT satisfies the requirements of Treas. Reg. § 25.2702-3.

b. If the requirements are not met and the interests in the closely-held business that are transferred to the GRAT are eventually to be transferred to the Grantor's family members, then the retained annuity must be valued at zero.

c. If the retained annuity interest is valued at zero, then the value of the annuity will be taxed twice to the Grantor, once when the trust is funded (because the value of the annuity is then zero) and a second time at death following the receipt of the annuity payments.

2. Payment of Annuity Amount. Treas. Reg. § 25.2702-3(b)(1).

a. The Grantor must have an irrevocable right to receive a fixed amount payable for each year of the term.

(i) "Fixed amount" means either a dollar amount or a fraction or percentage of the initial fair market value of the property conveyed to the GRAT as finally determined for gift tax purposes.

b. The annuity cannot be satisfied with a note. Under Treas. Reg. Section 25.2702-3(b)(1), issuance of a note, other debt instrument, option or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount.

c. Since a GRAT is a grantor trust, a portion of the interests in the closely-held business originally transferred to the GRAT could be returned to the Grantor in satisfaction of the annuity payment without any adverse tax consequences.

d. The annuity payment may be made after the close of the year if it is paid before the due date (without extensions) for the GRAT's income tax return.

e. The annuity payments can vary from year to year, but the annuity payable in any year cannot exceed 120% of the annuity paid in the previous year.

3. Incorrect valuations - Treas. Reg. § 25.2702-3(b)(2).

a. If the annuity amount is determined as a fraction or percentage of the value of the property transferred to the

GRAT, the trust instrument must require corrective payments if the amount is incorrectly determined.

b. This requirement mitigates the gift tax consequences of a revaluation of the transferred property by the IRS.

c. Revaluation right does not apply to incorrect valuations when property is used to pay the annuity in kind.

4. Proration for short years - Treas. Reg. § 25.2702-3(b)(3).

a. The GRAT must prorate the annuity payment for any year of less than 12 months.

5. Additional contributions prohibited. Treas. Reg. § 25.2702-3(b)(4).

a. The GRAT must prohibit additional contributions to the trust.

6. Distributions Only to Grantor - Treas. Reg. § 25.2702-2(d)(2).

a. The GRAT must prohibit distributions to anyone other than the Grantor during the GRAT Period.

7. Term of Annuity - Treas. Reg. § 25.2702-3(d)(3).

a. The GRAT must fix the term of the annuity based on a term of years, the life of the Grantor or for the shorter (but not longer) of those periods.

(i) In order to have a “Walton” GRAT (discussed below), GRAT should be structured solely as a term of years.

(ii) One of the proposals in the Treasury Department’s 2009 General Explanations of the Administration’s Fiscal year 2010 Revenue Proposals (the “Greenbook”), is to impose a 10-year minimum term on GRATs.

8. Commutation - Treas. Reg. § 25.2702-3(d)(4).

a. The GRAT must prohibit commutation (prepayment) of the interest of the holder.

(i) Query whether this means that annuity payments cannot be "advanced" prior to the required annuity payment dates.

C. Income Tax Consequences.

1. During the GRAT Period, the GRAT is a grantor trust under § 677(a)(1) because the Grantor retains the right to an annuity payable from income or principal.

2. However, if § 677 is the only basis for grantor trust qualification, the IRS could treat the Grantor as the owner of only the income portion and not the principal portion of the trust.

a. If GRAT will own S stock, it is critical that GRAT be treated as a grantor trust as to the entire trust.

b. If annuity amount is greater than § 7520 amount, then GRAT should be treated as a grantor trust as to the entire trust.

3. Grantor trust status is desirable for a GRAT both during and after the GRAT Period.

4. Reimbursement to Grantor for payment of income taxes.

a. If Grantor is entitled to be reimbursed for income tax payments, two adverse tax consequences may occur:

(i) The reimbursement right may cause the entire trust to be included in the grantor's estate for estate tax purposes; and

(ii) The Grantor's failure to take the reimbursement may be a gift after the opportunity to do so lapses.

b. Treas. Reg. Section 25.2702-3(b)(1)(iii) provides that an annuity interest does not fail to be a qualified annuity interest merely because the trust permits income in excess of the amount required to pay the annuity amount to be paid to or for the benefit of the holder of the qualified annuity interest. Nevertheless, the right to receive the excess income is not a qualified interest and is not taken into account in valuing the qualified annuity interest.

(i) No such permission is granted for various tax reimbursements that might include capital gains.

c. Instead of mandating reimbursement, may want to only give trustee discretion to reimburse Grantor for income taxes on income that is not distributed to the Grantor.

D. Gift Tax Consequences.

1. GRATs can be structured to produce a "zero" gift. Walton v. Comm'r, 115 TC 589 (2000), acq. in result Notice 2003-72, 2003-2 CB 964,

a. In order to have a "Walton" GRAT, the GRAT must provide:

(i) If the Grantor dies before the termination of the GRAT Period, any outstanding annuity payments must be payable to the Grantor's estate; and

(ii) The Grantor does not have any contingent reversionary interest in the trust assets in the event of death during the GRAT Period.

2. Since the annuity may be expressed as a percentage of the value of the assets transferred to the GRAT, there is protection against a large gift tax deficiency if values are adjusted on audit.

3. Generally, you don't want to split gifts to a GRAT between spouses. If the Grantor dies during the GRAT Period, the transaction is unwound as to the Grantor, but not as to the Grantor's spouse, in which case a portion of the spouse's applicable exclusion amount will be wasted.

E. Estate Tax Consequences.

1. If the Grantor dies during GRAT Period, the trust assets, or a portion thereof, will be includable in the Grantor's gross estate as determined solely under Section 2036 of the Code.

a. Treas. Reg. Section 20.2036-1(c)(2) provides that the portion of GRAT trust assets includible in the decedent's gross estate for Federal estate tax purposes is that portion of the trust corpus necessary to satisfy the remaining annuity payments as determined in accordance with Treas. Reg. Section 20.2031-7.

b. Treas. Reg. Section 20.2039-1(e) provides that Section 2039 will not apply in determining the portion of a GRAT to be included in a decedent's gross estate if the Grantor dies during the GRAT Period.

2. If the Grantor dies after the GRAT Period, then the family business interests transferred to the children (or to trusts for their benefit) will not be considered in determining whether the Grantor's estate is eligible for special tax treatment under §§ 303, 2032A, 2057 or 6166. However, if the Grantor dies during the GRAT Period, then the business interests owned by the GRAT should be considered since the interests will be included in the Grantor's estate.

F. Generation-Skipping Transfer Tax ("GST") Consequences.

1. § 2642(f) does not permit GST exemption to be applied to a GRAT until the end of the GRAT Period since that is the end of the estate tax inclusion period ("ETIP).

2. Because of the application of the ETIP rules to GRATs, the Grantor's GST exemption cannot be leveraged in the case of a GRAT.

a. However, some commentators have suggested gifting cash assets to a GST Exempt Trust and having such GST Exempt Trust purchase the GRAT remainder interest immediately following creation of the GRAT as a way to achieve GST planning with a GRAT.

G. When GRATs are Appropriate for Transfers of Interests in Closely-Held Family Businesses.

1. It can reasonably be anticipated that the Grantor will survive the GRAT Period.

a. In dealing with interests in closely-held businesses, in order to properly justify the valuation of the interests being transferred to the GRAT, it is generally recommended that the GRAT Period be at least 5 years.

2. The interests in the business transferred to the GRAT will generate sufficient cash flow to make the required annuity payments.

a. If the cash flow generated by the interests in the business owned by the GRAT is sufficient to satisfy the annuity payments, then at the end of the GRAT period all of the interests in the business and any excess dividends will be transferred to the business owner's children without the imposition of any additional gift tax.

b. If the GRAT is structured so that the present value of the annuity payments equal the initial value of the interests in the business transferred to the GRAT (after taking into account all available valuation discounts), then the amount of the initial gift for gift tax purposes should be zero.

c. If cash flow is not sufficient to satisfy the annuity payments, then the GRAT may need to distribute a portion of the interests in the business back to the Grantor. This would minimize the effectiveness of the initial gift.

3. The business is willing and able to distribute a proportionate amount of dividends to the other shareholders.

4. Example. (See Exhibit I). Assume a 60 year old business owner owns an S corporation with a total value of $10,000,000 that annually generates $1,750,000 of dividend income. Subsequently, assume that the business owner wishes to transfer 30% of non-voting stock of the S corporation to a GRAT during March 2010.

a. Assuming valuation discounts of 35%, the business owner will be deemed to have initially only transferred $1,950,000 ($10,000,000 X 30% X 65%) but it is anticipated that these interests will generate $525,000 ($1,750,000 X 30%) of dividend income.

b. Assuming a 5 year GRAT Period and the GRAT is structured as a “Walton” GRAT, the amount of the annuity payments should be approximately $430,000.

c. Based upon the 7520 rate for March 2010 of 3.2%, the gift in this case would be less than $1.

d. If the business owner survives the 5 year GRAT Period and dividends of $525,000 are annually declared to the shares owned by the GRAT, the business owner will have transferred 30% of the S corporation along with approximately $500,000 of excess dividends at no gift tax cost.

VI. <u>Transfers to Intentionally Defective Grantor Trusts ("IDGT")</u>.

A. <u>Trust Overview</u>.

1. Trust is irrevocable -- transfers to trust will be complete for gift tax purposes.

2. In contrast, trust will be ignored for federal income tax purposes. Thus, closely-held interests can be sold to trust with no immediate income tax consequences (more below).

3. Grantor will be required to include all items of trust income on Grantor’s income tax return.

4. Grantor's payment of the income tax liability generated by the IDGT's income is in effect a transfer tax free addition to the IDGT because the Grantor's payment of his own obligation is not a gift.

5. Trust typically is for benefit of Grantor’s descendants.

6. Some clients may wish to make trust a generation-skipping trust, particularly if they believe that closely-held interests will appreciate over time or if interests have a lower fair market value than their worth to the beneficiaries.

B. <u>Powers Used to Create Defective Trusts (while still allowing transfers to trust to be complete for gift tax purposes)</u>.

1. Give the Grantor the Power to Reacquire Trust Corpus by Substituting Property of an Equivalent Value (in a non-fiduciary capacity). § 675(4)(C).

   a. The IRS has taken the position that in order for this power to trigger grantor trust status a factual determination must be made at audit to determine if the power is held in a non-fiduciary capacity.

   b. Advantage: power can be released at Grantor’s option

2. Power of Grantor or Grantor's spouse to borrow without adequate interest or security. § 675(2).

   a. If the trustee (other than the Grantor) has a general power to lend to any person without regard to adequate interest or security, then this power will not achieve grantor trust status.

b. If Grantor has the absolute power to borrow rather than granting the Trustee the ability to lend to the Grantor, then may have a § 2036 retention problem.

3. Discretionary Power to Sprinkle Income and Principal. § 674(c).

a. Trustee must be a related or subordinate party subservient to the Grantor.

b. Problem: Grantor does not have ability to "turn off" this power.

4. Power to Add Beneficiaries § (674(b), (c) and (d).

a. The power to increase the class of beneficiaries (other than by adding after-born or after-adopted children) held by any nonadverse party will cause grantor trust status.

b. A power to add charitable beneficiaries to the class of individual beneficiaries is sufficient to render § 674(a) if the Trustee has discretion to distribute income and principal among multiple beneficiaries.

C. <u>Income Tax Consequences</u>.

1. While trust is defective.

a. Trust is ignored for federal income tax purposes -- assets in trust treated as owned by Grantor.

b. Sale of closely-held business interests to trust does not trigger federal income tax consequences because Grantor is treated as still owning closely-held business interests.

c. Interest payable by the trust to Grantor is not deductible by trust or included in Grantor's income for federal income tax purposes because it as if Grantor is paying the interest to Grantor.

d. Grantor must include all items of trust income on the Grantor's individual income tax return.

e. If trust is defective because of power that may be released by Grantor, Grantor should monitor trust activity carefully to determine whether Grantor wishes to release power. For example, if Grantor sold 99% of business to trust and, some years subsequent to sale, business is sold, Grantor would be responsible for all income taxes, even though only 1% of proceeds would be payable to Grantor.

2. Consequences Upon Release of Power that Makes Trust Defective or Death of Grantor.

   a. When trust ceases to be defective, a taxable event may occur. Examples:

      (i) Assume Grantor releases substitution power when trust is indebted to Grantor for $1,000,000. Release of substitution power by Grantor results in Grantor being deemed to have sold assets to trust in exchange for $1,000,000. If basis is less than $1,000,000, Grantor will have gain.

      (ii) Assume Grantor releases substitution power when trust is indebted to third party for $1,000,000. Immediately prior to release of power of substitution, Grantor was deemed to owe $1,000,000 to third party because trust was ignored for federal income tax purpose. Release of substitution power by Grantor characterized as trust assuming Grantor’s debt in exchange for Grantor transferring assets to trust. If trust assets have no value, consider debt cancellation issues.

   b. The income tax consequences resulting from the termination of grantor trust status as the grantor's death while the note is outstanding is uncertain. Three possible arguments:

      (i) The Grantor is deemed to have transferred the assets to a non-grantor trust immediately before the Grantor's death in exchange for a note (in which case any gain would be included in the Grantor's final income tax return);

      (ii) The Grantor is deemed to have transferred the assets to a non-grantor trust immediately after the Grantor's death in exchange for a note (in which case any gain would be included in the estate's initial fiduciary income tax return); or

(iii) No transfer is recognized for income tax purposes at the Grantor's death.

c. If the Grantor is deemed to have transferred the assets to a non-grantor trust immediately before the Grantor's death in exchange for a note, then

(i) No basis adjustment under § 1014.

(ii) The Grantor's income tax liability is a debt deductible under § 2053.

(iii) The IDGT's basis will be equal to the deemed purchase price.

d. If the Grantor is deemed to have transferred the assets to a non-grantor trust immediately after the Grantor's death in exchange for a note, then

(i) May be able to argue that the assets receive a step-up in basis under § 1014.

(ii) There should be no recognizable gain by the holder of the note if the assets receive a step-up in basis (either to fair market value or the amount outstanding on the note) before the sale by the Grantor's estate.

e. If the sale is deemed to occur after death, then may be able to argue that § 1014(a) applies to the promissory note (not to the property sold).

3. Negative income tax implications following the death of the Grantor can be avoided by paying off the note before the Grantor's death.

a. In order to minimize risk, may wish to consider using an amortized note rather than an interest only note.

D. Gift Tax Consequences.

1. Transfer to IDGT may be gift, sale, or combination of both.

2. Sale portion will not trigger gift taxes if sale is for full and adequate consideration.

   a. Valuing business interests (*i.e.*, determining amount of consideration to be paid) is difficult, but formulaic transfers may help. Nothing will completely protect from gift and generation-skipping transfer tax risk.

   b. If the sale is for a promissory note, and the promissory note bears interest at the applicable federal rate, the note should be valued at its face amount.

      (i) Note should be secured by transferred property.

      (ii) Recommended for trust to have assets other than transferred property (consider 10 to 1, debt to equity ratio).

      (iii) If desirable to have beneficiary serve as guarantor, beneficiary should be paid a guarantee fee.

      (iv) Payments due under note need to be made promptly, and trust needs to have adequate income to make payments.

E. Estate Tax Consequences.

1. Upon the death of Grantor, only the value of the outstanding note will be included in the Grantor's estate for estate tax purposes. None of the IDGT assets should be included in Grantor's estate.

2. If the note has been paid off prior to death, nothing will be included in the Grantor's estate for estate tax purposes.

3. The business interests owned by the IDGT will not be considered in determining whether the Grantor's estate is eligible for special tax treatment under §§ 303, 2032A, 2057 or 6166 regardless of whether or not the note has been paid off prior to death.

F. When Installment Sales to IDGTs are Appropriate for Transfers of Interests in Closely-Held Family Businesses.

1. The interests in the business sold to the IDGT will generate sufficient cash flow to pay off the note's obligations.

2. Example. (See Exhibit II). Assume the 60 year old business owner discussed above sells 30% of the non-voting stock of his $10,000,000 S corporation during March 2010 to an IDGT in exchange for a 5 year promissory note in the amount of $1,950,000 following a gift by the business owner to the IDGT of $200,000.

   a. Assuming valuation discounts of 35%, as long as the promissory note bears interest at 2.69% (the March 2010 mid-term AFR rate), then the purchase price of $1,950,000 will result in no gift since it is equal to the value of the interests being sold ($10,000,000 X 30% X 65%).

   b. If the note is structured so that payments of approximately $422,000 are amortized and the business owner survives the 5 year installment payment period, assuming the dividends of $525,000 are annually declared to the shares owned by the IDGT, then the business owner will have transferred 30% of the company and approximately $600,000 of excess dividends at no gift tax cost.

   c. If the note is interest only, the amount of excess dividends would be approximately $800,000.

      (i) By using the mid-term AFR rate, the promissory note could be extended to just under 9 years without any adverse tax consequences, thereby increasing the amount of potential excess dividends even further.

   d. Since the IDGT allows the business owner to use more favorable IRS interest rates, the tax savings resulting from the IDGT can be significantly better than those achieved by the GRAT.

VII. <u>Comparison of GRATs to IDGTs</u>.

A. <u>Issues Common to Both GRATs and Sales to IDGTs</u>.

1. At end of GRAT Period or after the note has been paid off, the business owner will no longer be entitled to receive any economic benefit associated with the stock transferred to the GRAT or sold to the IDGT.

2. Illiquid businesses with little or no cash flow are not good prospects for either technique, but IDGT requires less cash flow in earlier years.

B. General Risks.

1. GRAT.

a. The rules are clearly laid out. Accordingly, a more conservative client (or advisor), may feel more comfortable using a GRAT.

b. Gift Tax Statute of Limitations. Assuming the GRAT transaction is properly disclosed on a gift tax return, the business owner can rely on the gift tax statute of limitations.

2. Sale to IDGT

a. The IRS has not expressly sanctioned its use and no court has adjudicated the merits of a sale to an IDGT.

b. Gift Tax Statute of Limitations. If the transaction is not disclosed on a gift tax return, the statute of limitations will not expire on the assessment of gift tax.

C. Estate Tax Risk.

1. GRAT - If business owner dies during the GRAT Period, the transaction is unwound and generally speaking the value of the transferred business interests as of the date of death will be included in the business owner's estate.

2. Sale to IDGT - If business owner dies while note is outstanding, the only amounts included in the business owner's estate will be the value of the note. All appreciation on the transferred interests following the date of sale will still escape transfer taxation.

D. Income Tax Risk.

1. GRAT - If business owner dies during the term of the GRAT, the transferred business interests will be brought back into the estate and will receive a step-up in basis for income tax purposes to its fair market value as of the date of death.

2. IDGT - If business owner dies while note is outstanding, a capital gains tax may be due and owing on the difference between the business owner's basis in the stock and the sales price.

E. Weighing Estate Tax Risk vs. Income Tax Risk.

1. If the business owner believes the business interests have significant appreciation potential, then the sale to the IDGT is probably more preferable since the estate tax benefits should outweigh the income tax costs associated with a premature death.

2. If the business owner believes the appreciation potential is only modest, then the GRAT technique may be more preferable in order to eliminate any negative income tax risks.

F. Valuation Risk.

1. Appraisers.

a. It is generally recommended that a qualified appraiser be engaged to determine the proper value of the business interests being transferred.

b. Even if valuations are based upon qualified appraisals, the risk still exists that the IRS will revalue the business interests for purposes of the GRAT or the Sale to the IDGT.

2. GRAT - If the IRS revalues the business interests and the GRAT payments are structured as a percentage of the value of the business interests, then the GRAT payment will increase based upon such adjustment. While there may be no resulting material increase in gift taxes, the amount of potential estate tax savings may be reduced significantly.

3. Sale to IDGT - If the IRS revalues the business interests, then the business owner will be deemed to have made a gift equal to the difference between the amount of the business interests as determined by the IRS and the amount of the note, although there is some possibility of mitigating this risk with use of formulaic or defined-value transfers or possibly net gifts (net gift only mitigates risk to transferor, although overall gift tax paid will be less in a net gift situation).

VIII. Other Variations and Alternatives - SCINs and Private Annuities.

A. Self Canceling Installment Notes ("SCINs").

1. Overview of Technique.

a. Same as the sale to the IDGT except that the note provides that the obligation extinguishes upon the death of the business owner.

b. In order to cover the actuarial cost borne by the business owner, either the note's principal or it's interest rate must be increased.

c. The term of the note must be less than the business owner's life expectancy.

2. Income Tax Consequences.

a. The business owner is required to compute and report the gain as if all payments due under the note will be paid.

b. If the business owner dies before all payments have been made, the unrealized gain will be triggered in the first return of the estate as a cancellation of an installment obligation.

c. The IDGT's basis in the transferred interests will be the face value of the note, regardless of whether the business owner dies before the note is paid off.

3. Gift Tax Consequences.

a. As long as there is a premium in the interest rate or in the purchase price to reflect the self-canceling feature, there should be no gift.

b. However, SCIN must have economic reality.

(i) If the business owner is in poor health at the time of sale (and in fact dies a short time thereafter), a SCIN may be considered a taxable gift.

(ii) Purchaser should have sufficient assets to make the required payments.

4. Estate Tax Consequences.

a. Upon the death of the business owner, the value of the SCIN will be zero since no further payments will be received.

5. <u>When SCINs are Appropriate for Transfers of Interests in Closely-Held Family Businesses</u>.

a. If it appears the business owner's life expectancy is less than the § 7520 actuarial tables.

(i) However, in order to be entitled to use the § 7520 tables, death cannot be imminent.

(ii) If business owner survives the term of the note, then he would have received back more than he otherwise would have had the note not been a SCIN in the first instance.

B. <u>Private Annuities</u>.

1. <u>Overview of Technique</u>.

a. The business owner sells an interest in the business to a family member in exchange for an annuity (usually measured by the business owner's lifetime).

b. In order to avoid immediate taxation of gain from the sale, the annuity must be unsecured.

c. The business owner cannot retain any interest in the transferred property and the payment of the annuity cannot be tied to income from the interests in the business that were transferred.

d. Upon the death of the business owner, the annuity payments will terminate.

2. <u>Income Tax Consequences to the Seller (the business owner)</u>.

a. The income stream provided to the business owner will be part capital gain and part ordinary income which is spread over the period of the annuity payments.

b. The annuity payments under the private annuity are taxed under the § 72 actuarial tables except that a portion of each payment corresponding to the appreciation used to purchase the annuity will be taxed as capital gain.

c. The rules setting forth the relevant items of income are set forth in Rev.Rul. 69-74, 1969-1 C.B. 43, as modified by the requirements of § 7520.

3. Income Tax Consequences to the Buyer.

a. Buyer's Basis.

(i) Buyer's basis in purchased interest is equal to the amount of payments actually made.

(ii) The buyer's initial basis is the value of the annuity.

(iii) If the business owner lives less than expected, the buyer's basis will be adjusted downward to the total of payments made.

(iv) If the business owner lives longer than expected, the buyer's basis will be adjusted upward to the total of payments made.

b. Interest.

(i) Even though a portion of each annuity payment will be considered ordinary income to the seller, no portion of the buyer's payments are deductible since they are considered capital expenditures by the buyer.

4. Gift Tax Consequences.

(i) If the annuity has a value equal to the business interests given for it, there will be no gift tax consequences associated with the transfer.

(ii) The method for valuing the annuity is set forth in Rev. Rul. 84-162, 1984-2 C.B. 200.

(iii) In order for no gift to occur, the annuity payments need to be higher than they otherwise would have been under an installment sale for a term equal to the business owner's life expectancy.

5. <u>Estate Tax Consequences</u>.

   a. If the annuity payments terminate upon the business owner's death, then the original transferred business interests that the business owner sold in exchange for the annuity will not be included in the business owner's estate upon death.

   b. Any annuity payments received by the business owner during lifetime that were not consumed will be included in the business owner's estate.

6. <u>When Private Annuities are Appropriate for Transfers of Interests in Closely-Held Family Businesses</u>.

   a. If it appears the business owner's life expectancy is less than the § 7520 actuarial tables.

      (i) However, in order to be entitled to use the § 7520 tables, death cannot be imminent.

   b. When the business owner will need a cash flow stream from the business for the remainder of their lifetime.

      (i) Instead of treating all of such payments as compensation (or consulting income), only a portion of the annuity payment will be considered ordinary income and the remaining portions will be considered capital gain and a return of capital.

      (ii) This reduces the amount of funds needed to distribute to the business owner to achieve the same after-tax results.

Exhibit II

Sale to Intentionally Defective Grantor Trust (IDGT)

Age of Business Owner:	60
Value of Entire Business:	$10,000,000
Cash Flow Generated by Entire Business:	$1,750,000
Percentage of Business Interests Being Transferred:	30%
Applicable Valuation Discounts:	35%
Amount of Business Interests Being Transferred:	$1,950,000
Cash Flow Generated by Business Interests Being Transferred:	$525,000
Date of Transfer:	Mar-10
Mid-Term AFR Rate for Date of Transfer:	2.69%
Period of Note:	5
After tax rate of return on cumulative excess earnings:	7.50%

Option 1 - Amortized Note Payment

Amount of Payment = $422,030

Year	Interest Due	Payment	Note Balance	Dividends Received	Annual Excess Earnings	Cumulative Excess Earnings
			$1,950,000			
1	$52,455	($422,029.79)	$1,580,425	$525,000	$102,970	$102,970
2	$42,513	($422,029.79)	$1,200,909	$525,000	$102,970	$213,663
3	$32,304	($422,029.79)	$811,184	$525,000	$102,970	$332,658
4	$21,821	($422,029.79)	$410,975	$525,000	$102,970	$460,578
5	$11,055	($422,029.79)	$0	$525,000	$102,970	$598,091

Option 2 - Interest Only Note Payments

Amount of Payment = $52,455

Year	Interest Due	Interest Payment	Principal Payment	Note Balance	Dividends Received	Annual Excess Earnings	Cumulative Excess Earnings
				$1,950,000			
1	$52,455	($52,455.00)		$1,950,000	$525,000	$472,545	$472,545
2	$52,455	($52,455.00)		$1,950,000	$525,000	$472,545	$980,531
3	$52,455	($52,455.00)		$1,950,000	$525,000	$472,545	$1,526,616
4	$52,455	($52,455.00)		$1,950,000	$525,000	$472,545	$2,113,657
5	$52,455	($52,455.00)	($1,950,000)	$1,950,000	$525,000	$472,545	$794,726