

**Some of the Best Estate Planning Ideas We See Out There
(That Also Have the Merit of Playing Havoc With Certain “Conventional Wisdom”)**



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Best Non-Tax Planning Idea – Or Why Investment Professionals Love Limited Liability Companies and/or Limited Partnerships (Pages 1 through 32 of the Paper)

Conventional Wisdom:

- “For the passive trustee investor, there does not exist any substantive non-tax investment reason to invest in a family limited partnership;” or
- “Congress has not expressed its intent in the Internal Revenue Code as to under what circumstances, for transfer tax purposes, family limited partnerships should be recognized apart from its owners as a permissible organizational form for passive investors in marketable stocks and bonds.”

This “conventional wisdom,” under the circumstances discussed below, is incorrect.

Example: Marvin and Maggie Modern Wish to Create Several Trusts For the Benefit of Family Members and Follow Modern Portfolio Theory

Marvin and Maggie Modern wish to give \$300,000 to separate trusts for each of their grandchildren. Marvin and Maggie understand modern portfolio theory and the importance of diversification. They want the grandchildren's trusts to invest for the greatest risk-adjusted return and are concerned that the trusts will not be large enough to meet SEC limitations on who may invest in certain alternative asset classes.

In addition to current gift planning, Marvin and Maggie want to provide a qualified terminal interest marital deduction trust ("QTIP") for the surviving spouse under their estate plans. Many of their personal alternative asset investments are held in private equity partnerships now. Marvin and Maggie worry that these investments could cause income tax fairness issues for the QTIP trust – that is, they worry that the surviving spouse, as income beneficiary, may bear a disproportionate amount of income tax liability on the alternative investments - but still feel strongly that the QTIP trust should have exposure to alternative asset classes.

Marvin and Maggie ask their attorney, Pam Planner, how to structure their investment portfolio so the trustees for their grandchildren's individual trusts and the survivor's QTIP trust can invest in the broad array of asset classes necessary to maximize risk-adjusted return under modern portfolio theory.

Best Non-Tax Planning Idea – Or Why Investment Professionals Love Limited Liability Companies and/or Limited Partnerships (Continued)

- The first investment reason certain trusts are benefited by the creation of family limited partnerships: closely held family limited partnerships may facilitate a trust holding alternative investments and the trust's ability to follow modern portfolio theory.
 - Certain exceptions to the registration requirements under the Securities Exchange Act of 1933, the Securities Exchange Act of 1934 and the Investment Company Act of 1940 are important to many issuers of alternative investments (e.g., investments such as oil and gas, real estate and other private equity investment funds).
 - It is important that those alternative investment funds be held by “accredited investors” and/or “qualified purchasers”.
 - If the Moderns first create a family limited partnership, and then give family limited partnership units to the trusts for the grandchildren, then the accredited investor and qualified purchaser exceptions may apply. In that manner the trust investments would follow modern portfolio theory.

Best Non-Tax Planning Idea – Or Why Investment Professionals Love Limited Liability Companies and/or Limited Partnerships (Continued)

- The second investment reason certain trusts are benefited by the creation of family limited partnerships: closely held family limited partnerships facilitate income only (so-called simple) trusts to be fully diversified, as modern portfolio theory seems to require.
 - Closely held family limited partnerships could be a tool to manage distribution fairness issues for income only trusts associated with distributions (or lack of distributions) from alternative investments.
 - Unitrust conversion does not help because of valuation issues with hedge funds and private equity investments.
 - Distributions of private equity and fund investment units cannot be made because of securities concerns.
 - If other assets are distributed it could potentially distort the overall asset allocation.
 - Closely held family limited partnerships could be a tool to manage income tax fairness issues associated with alternative investments for income only trusts.
 - One cash distribution could be made from a family limited partnership to an income only trust and designated as trust accounting income.
 - A second cash distribution could be made from a family limited partnership to an income only trust and designated as corpus to pay trust income taxes.

Best Non-Tax Planning Idea – Or Why Investment Professionals Love Limited Liability Companies and/or Limited Partnerships (Continued)

- The third investment reason certain trusts are benefits by family limited partnerships: the closely held family limited partnership has the management capacity to carry out the partnership's capital gains income to the income only beneficiary for income tax purposes.
 - Under UPIA Section 401, a distribution of cash from an entity to a trust may be deemed to have carried out capital gain income as trust accounting income, if a trustee does not have distribution control over a family limited partnership.
 - A trustee can only allocate receipts from the entity between income and principal according to the trust agreement or UPIA Section 401.

Best Financial Engineering Plan Idea – The Private Call Spread Option or Put Spread Option That is Contributed to a GRAT (Pages 32 through 53 of the Paper)

Conventional Wisdom:

- “Using a short term GRAT to transfer a family limited partnership interest does not work;” or
- “GRATs only work in good markets.”

This “conventional wisdom,” under the circumstances discussed below, is incorrect.

What is a Call Option?

- The buyer of a call option has the right to purchase stock from the seller of a call option at a certain price in the future (the “exercise price”).
- The purchase price of a call (the “premium”) is generally a portion of the value of the stock at the time the buyer purchases the call.
- If the stock price is at or above a specified value (the “target value”) on a specified date (the “target date”), the buyer can purchase the stock from the seller of the call option at the exercise price.
- If the stock price is less than the target value on the target date, the buyer can’t purchase the stock from the seller. That means that the buyer loses the premium paid for the call option to the seller.
- If the stock price is at or above the target value on the target date, the seller must sell the stock to the buyer for the exercise price. The seller keeps the premium and the exercise price, but the sum of those two is less than the stock’s value on the target date.

Simplified Call Option Example

When XYZ Company stock is \$50 per share, the buyer of a call option pays the seller a \$7 premium for the right to buy XYZ Company stock for \$55 (the exercise price) at a future date.

Buyer's net worth increases: On the target date, the XYZ stock is trading at \$65. The buyer will pay the seller the exercise price of \$55 to get the stock. The seller will have the original call option premium of \$7 and the exercise price of \$55, but that is \$3 less than the value of the XYZ Company stock. The buyer will have paid \$62 (the \$7 premium and the \$55 exercise price) to own a \$65 stock. The buyer's net worth increases by \$3.

Seller's net worth increases: On the target date, the XYZ stock is trading at \$52. The buyer won't pay \$55 to purchase the stock, so the seller keeps the \$7 premium. The seller's net worth increases by \$7.

The most the buyer can lose is the \$7 premium.

Theoretically, the seller can lose an unlimited amount if the price of XYZ Company skyrockets, unless the seller owns the same amount of stock in XYZ Company (a so-called "covered call").

What is a Call Spread Option?

- When we described a call option on the previous page, we looked at the buyer's perspective. But the seller might do more than just sell a call option. The seller might buy a call option too.
- In a call spread option, the seller invests a portion (or all) of the purchase price the buyer paid for the call option to buy a different call option. This call option that the seller purchases for herself has a target value below the target value of the call option she sold.
- On the target date, the seller makes money if the stock price is between the higher value of the call option the seller sold and the lower target value of the call option the seller purchased.
- It's important to know that a call spread option limits losses, but it also limits gains.

Simplified Call Spread Option Example

When XYZ Company stock is \$50 per share, the buyer of a call option pays the seller a \$7 premium for the right to buy XYZ Company stock for \$55 (the exercise price) at a future date and that buyer then sells a call option for \$3 to another buyer for the right to buy XYZ Company stock for \$65 at the same future date.

Buyer's net worth increases: On the target date, the XYZ stock is trading at \$65. Assume the call spread contract is cash settled. The buyer will gross \$10 on his \$4 net investment.

The most the buyer of the call spread option can lose is the \$4 net premium.

Theoretically, the seller of a call spread option, under the above assumed facts, cannot lose more than \$6 after the net premium received is considered.

What is a Put Option?

- The buyer of a put option has the right to sell stock to the seller of a put option at a certain price in the future (the “exercise price”).
- The purchase price of a put (the “premium”) is generally a portion of the value of the stock at the time the buyer purchases the put.
- If the stock price is at or below a specified value (the “target value”) on a specified date (the “target date”), the buyer of the put option can require the seller to purchase the stock from the buyer the exercise price.
- If the stock price is more than the target value on the target date, the seller does not have to purchase the stock from the buyer. That means that the buyer loses the premium paid for the put option to the seller.
- If the stock price falls to target value or below on the target date, the seller must purchase the stock from the buyer for the exercise price or settle the difference in value for cash.

Simplified Put Option Example

When XYZ Company stock is \$50 per share, the buyer of a put option pays the seller \$7 (the “premium”) for the right to sell XYZ Company stock to the seller for \$40 (the exercise price) at a future date.

Buyer’s net worth increases: On the target date, the XYZ stock is trading at \$30. The buyer will sell the stock to the seller of the put option for the \$40 exercise price. The buyer of the put option will have \$40 from the seller, less the \$7 premium previously paid. The buyer’s stock was only worth \$30 when the buyer exercised the put option, so the buyer nets \$33 (\$40 stock price less the \$7 premium) and the buyer’s net worth increases by \$3.

Seller’s net worth increases: On the target date, the XYZ stock is trading at \$45. The buyer won’t sell the stock to the seller of the put option for \$40, so the seller keeps the \$7 premium. The seller’s net worth increases by \$7.

The most the buyer of the put option can lose is the \$7 premium.

Theoretically, the seller can lose the entire \$40 exercise price of the stock if the stock price falls to zero, but the seller will still get to keep the \$7 premium.

What is a Put Spread Option?

- When we described a put option on the previous page, we looked at the buyer's perspective. But the seller might do more than just sell a put option. The seller might buy a put option too.
- In a put spread option, the seller invests a portion (or all) of the purchase price the buyer paid for the put option to buy a different put option. This put option that the seller purchases for herself has a target value above the target value of the put option she sold.
- On the target date, the seller makes money if the stock price is between the lower value of the put option the seller sold and the higher target value of the put option the seller purchased.
- It's important to know that a put spread option limits losses, but it also limits gains.

Simplified Put Spread Option Example

When XYZ Company stock is \$50 per share, the buyer of a put option pays the seller \$7 (the “premium”) for the right to sell XYZ Company stock to the seller for \$40 (the exercise price) at a future date and that buyer then sells a put option for \$3 to another buyer for the right to sell XYZ Company stock for \$30 at the same future date.

Buyer’s net worth increases: On the target date, the XYZ stock is trading at \$30. Assume the call spread contract is cash settled. The buyer will gross \$10 on his \$4 net investment.

The most the buyer of the put spread option can lose is the \$4 net premium.

Theoretically, the seller of a put spread option, under the above assumed facts, cannot lose more than \$6 after net premium received is considered.

- Valuation advantages – Annuity automatically adjusts on asset revaluation
- Grantor may pay for income taxes associated with GRAT gift tax-free
- Grantor may substitute assets of the GRAT income tax-free
- Synergy with other techniques
- Comparatively low hurdle rate
- High leverage
- Non-recourse risk to remaindermen

- We'll see below that a GRAT transfers value to the remainder beneficiaries when its assets are sufficiently volatile – that is, when the assets contributed have the potential for large swings in value.
- When a client contributes an asset outright to a GRAT (financial engineers say the client is “long” the asset), the GRAT succeeds only if the asset appreciates above the 7520 rate. The pressure is on the client or the advisor to select just the right asset for the GRAT term.
- Financial engineering expands the possibilities for successful GRAT.

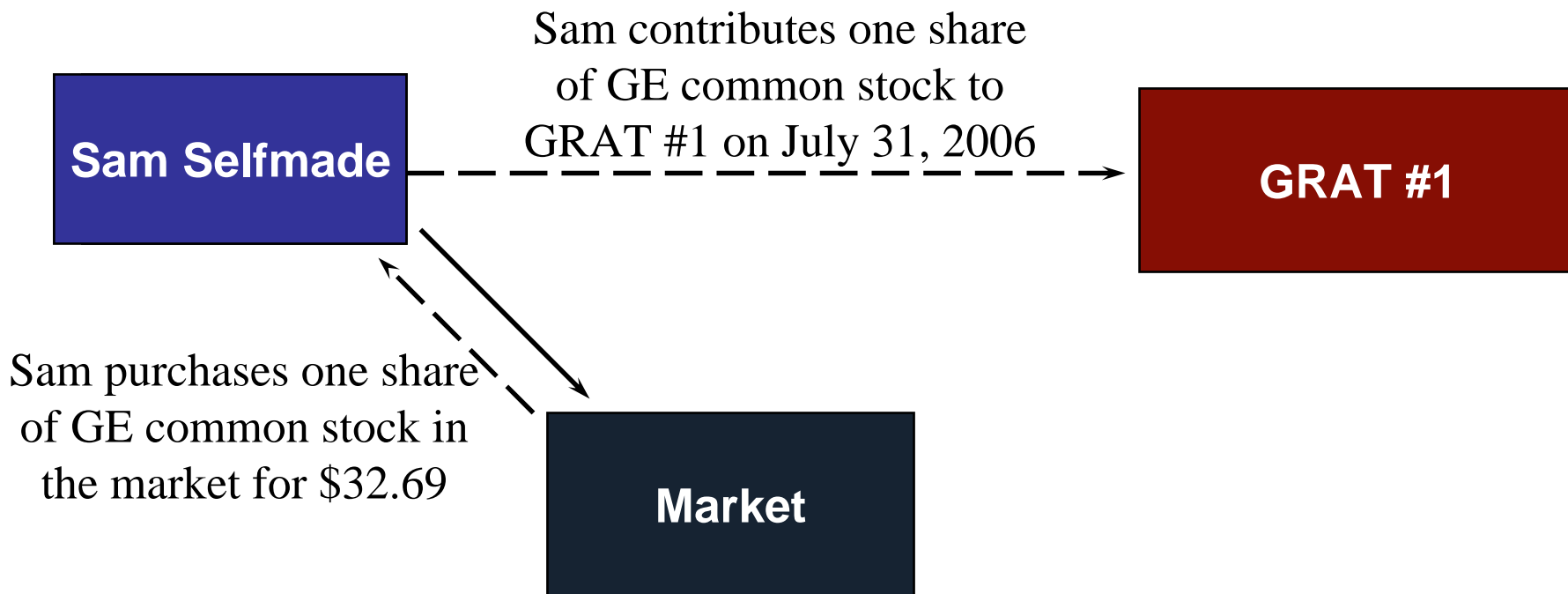
Example: Grantor of GRAT Enhances the Likelihood of Exceeding the Statutory Rate By Contributing a Derivative (Which is the Result of a Private Transaction With the Grantor's Spouse or a Marital Deduction Trust That is Also a Grantor Trust) to a GRAT

Many years ago, Sam Selfmade's company merged with General Electric. Sam received General Electric stock as a result of that merger. In 2005, Sam, with his wife Sally and their children put some of their General Electric stock in a family limited partnership. Sam and Sally still own a significant part of their General Electric stock outside of the partnership.

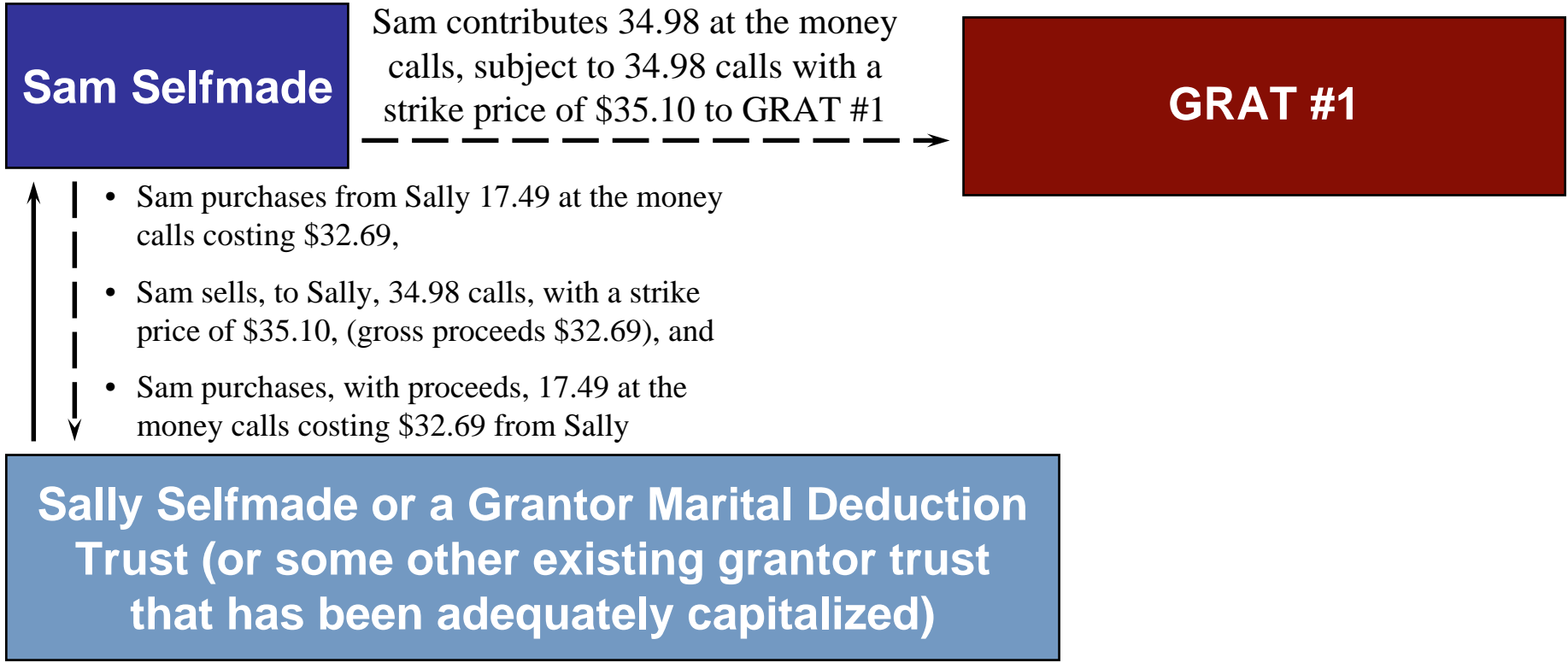
Sam Selfmade, on July 31, 2006, wishes to compare over a one year period the possible results from entering into a variety of private derivative transactions involving GE stock with either his spouse, Sally Selfmade, or a marital deduction trust he created for her benefit, acting as the financial counterparty, and contributing his derivative to a GRAT.

Sam wishes to compare the various results if he simply contributes his GE stock to a traditional GRAT.

Transaction 1 (Traditional Investment GRAT, No Options): Sam Selfmade Purchases a Share of GE Common Stock for \$32.69 and Contributes it to GRAT #1



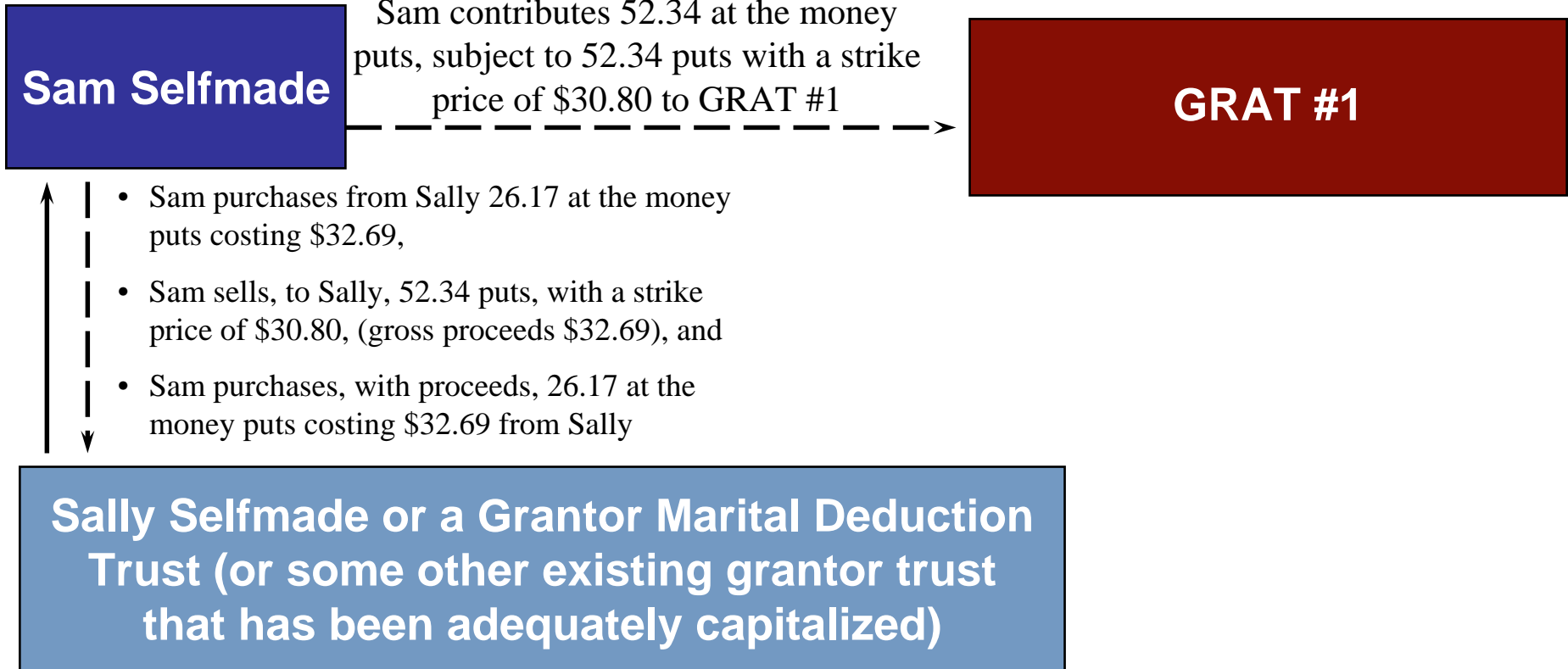
Transaction 2 (Call Option Spread, One GRAT): Sam Selfmade Purchases, from Sally Selfmade, 17.49 at the Money Calls; Sam Selfmade Sells 34.98 Calls, with Strike Prices of \$35.10, to Sally Selfmade; Sam Selfmade Contributes the 17.49 at the Money Calls, Subject to 34.98 Calls with a Strike Price of \$35.10, to GRAT #1



Assuming that Sam Selfmade is willing to contribute, to a GRAT, assets that have a net value of \$32.69. Transactions are assumed to take place on July 31, 2006.

The premium paid for the option and/or the settlement of the option could be with Sam Selfmade’s partnership units or the marital deduction trust’s partnership units.

Transaction 3 (Put Option Spread, One GRAT): Sam Selfmade Purchases, from Sally Selfmade, 52.34 at the Money Puts; Sam Selfmade Sells 52.34 Puts, with Strike Prices of \$30.80, to Sally Selfmade; Sam Selfmade Contributes the 52.34 at the Money Puts, Subject 52.34 Puts with a Strike Price of \$30.80, to GRAT #1



Assuming that Sam Selfmade is willing to contribute, to a GRAT, assets that have a net value of \$32.69. Transactions are assumed to take place on July 31, 2006.

The premium paid for the option and/or the settlement of the option could be with Sam Selfmade's partnership units or the marital deduction trust's partnership units.

GRAT Remainderman's Return at the End of One Year as a Percentage of the Initial Contribution to the GRAT

Stock Price	Increase (Decrease) in the Value of GE Stock	Transaction 1	Transaction 2	Transaction 3
\$10.00	-69.41%	0.00%	0.00%	196.44%
\$15.00	-54.11%	0.00%	0.00%	196.44%
\$20.00	-38.82%	0.00%	0.00%	196.44%
\$25.00	-23.52%	0.00%	0.00%	196.44%
\$27.00	-17.41%	0.00%	0.00%	196.44%
\$28.00	-14.35%	0.00%	0.00%	196.44%
\$29.00	-11.29%	0.00%	0.00%	196.44%
\$30.00	-8.23%	0.00%	0.00%	196.44%
\$30.80	-5.78%	0.00%	0.00%	196.44%
\$31.00	-5.17%	0.00%	0.00%	164.42%
\$32.00	-2.11%	0.00%	0.00%	4.29%
\$33.00	0.95%	0.00%	0.00%	0.00%
\$35.00	7.07%	0.87%	140.99%	0.00%
\$35.10	7.37%	1.17%	151.69%	0.00%
\$41.00	25.42%	19.22%	151.69%	0.00%
\$50.00	52.95%	46.75%	151.69%	0.00%
\$55.00	68.25%	62.05%	151.69%	0.00%
\$60.00	83.54%	77.34%	151.69%	0.00%

Transactions are assumed to take place on July 31, 2006.

For a Single GRAT, Why Do Call Option Spreads (Option 2) Work So Well? The Answer is Extreme Leverage as Noted Below For GE Stock (Assuming the GRAT was Created on July 31, 2006)

Transaction	Assets of the GRAT, Which Are Worth \$32.69 on July 31, 2006	The Amount of Growth in Value That GE Must Achieve Before GRAT Remaindermen Receive Value (Breakeven Point)	The Amount GRAT Remaindermen Will Receive For Every Dollar of Growth of a Share of GE Stock Once Breakeven Point is Achieved
Transaction 1	One share of GE stock	\$2.03	\$1
Transaction 2	34.98 at the money call, subject to 34.98 calls with a strike price of \$35.10	\$0.99	\$34.99

Refinements of the Technique

- What if Sam Selfmade purchases both a call spread option and a put spread option from the marital deduction trust for Sally's benefit, and then contributes each option to different GRATs with different annuity payouts and different remainderman provisions? Investors sometimes make that purchase (the so-called "winged-tip" strategy) when they are betting on market volatility. There are circumstances when neither strategy would work (because that stock is flat or the markets are flat). Even so, in most instances one of the GRATs will always work and the failure of the other will be costless (apart from administrative costs). This bothers the practitioner who applies a "too good too be true" test.
- A more conservative approach, and just as an effective approach in the long term, would be for Sam Selfmade to use his judgment as to whether GE stock is going to be higher or lower and purchase a call spread or put spread option, but not both. If Sam's judgment is incorrect, he could do another transaction at a later time. Eventually, Sam's judgment will presumably be correct, and at that time he will have a successful GRAT with this cascading GRAT strategy.

Refinements of the Technique (Continued)

- Assuming Sam's judgment is eventually correct, Sam and his family will not be disadvantaged by the cascading GRAT strategy except for the continuing legal costs in creating the GRATs. One way to ameliorate that concern, and to create evidence as to the fair market value of the private call spread option or put spread option, is for Sally Selfmade, or her marital deduction trust, to sell, for a premium, a very small part (e.g. 5%) of the transaction to an independent third party. If the private call spread option expires worthless, the independent third party call spread option will also expire worthless. The Selfmade family will, under those circumstances, "pocket" the third party premium, which could pay for the legal costs of creating the unsuccessful GRAT that holds the private call spread option.
- The annuity payout percentage of the GRAT that is funded with a private derivative should be around 90% of the original fair market value in first year and around 12% in the second year. The result, or success of the transaction, will be known by the end of year one. In effect, the large annuity payout in year one creates a GRAT that performs similar to a one year GRAT. It should be noted that there is not any express support or prohibition in the treasury regulations with respect to decreasing annuity payouts for GRATs.

Refinements of the Technique (Continued)

- As noted above, the payment of the premium by Sam to the grantor marital trust could be “in kind” (e.g., shares of a subchapter S trust or family limited partnership units). Likewise, the marital deduction trust could settle the option contract “in kind”. In this manner, the technique could be used to transfer, assuming a successful GRAT, any of the client’s assets.

Using Private Derivatives to Hedge Grantor Trust Investments and to Transfer Wealth

Example: A Trust Wishes to Hedge its ETF Investment By Entering Into a Twin-Win Derivative With its Grantor

Tom Trustee enters into a cashless derivative with Connie Counterparty who is the grantor of the trust and Connie contributes her position to a GRAT.

Tom Trustee is trustee of a grantor trust that was created many years ago by Connie Counterparty. The trust has a significant position in an ETF that mimics the S&P 500 stock index. On March 2, 2009, Tom decides to hedge the ETF position. Tom approaches a big investment bank and sells two out of the money calls with respect to his S&P 500 index ETF that are 13% out of the money. These two call positions are a 53 week European style options. The proceeds of the sale of those two out of the money call positions are then utilized to buy one at the money call position that is also a 53 week option and two knock out puts that protect the ETF for any decrease that does not exceed 20% of the position of the ETF in 53 weeks. Thus, Tom is in a position to enjoy a \$2.00 profit for every dollar increase in the value of the ETF position until it increases more than 13% and will enjoy \$1.00 increase every time the ETF position decreases by \$1.00 until it decreases by more than 20%. Tom will not regret the trade unless the stock index grows by more than 26% in the 53 week period.

Using Private Derivatives to Hedge Grantor Trust Investments and to Transfer Wealth (Continued)

Connie Counterparty learns about the trade that Tom Trustee is entering into with the investment bank. Connie suggests to Tom that she would like to do the same trade with Tom. That is, Connie will purchase two out of the money call positions from Tom, as trustee, and Tom, as trustee, can use those proceeds to buy from her at the money call position and two knock out puts. All of the positions with Connie will also be 53 week options.

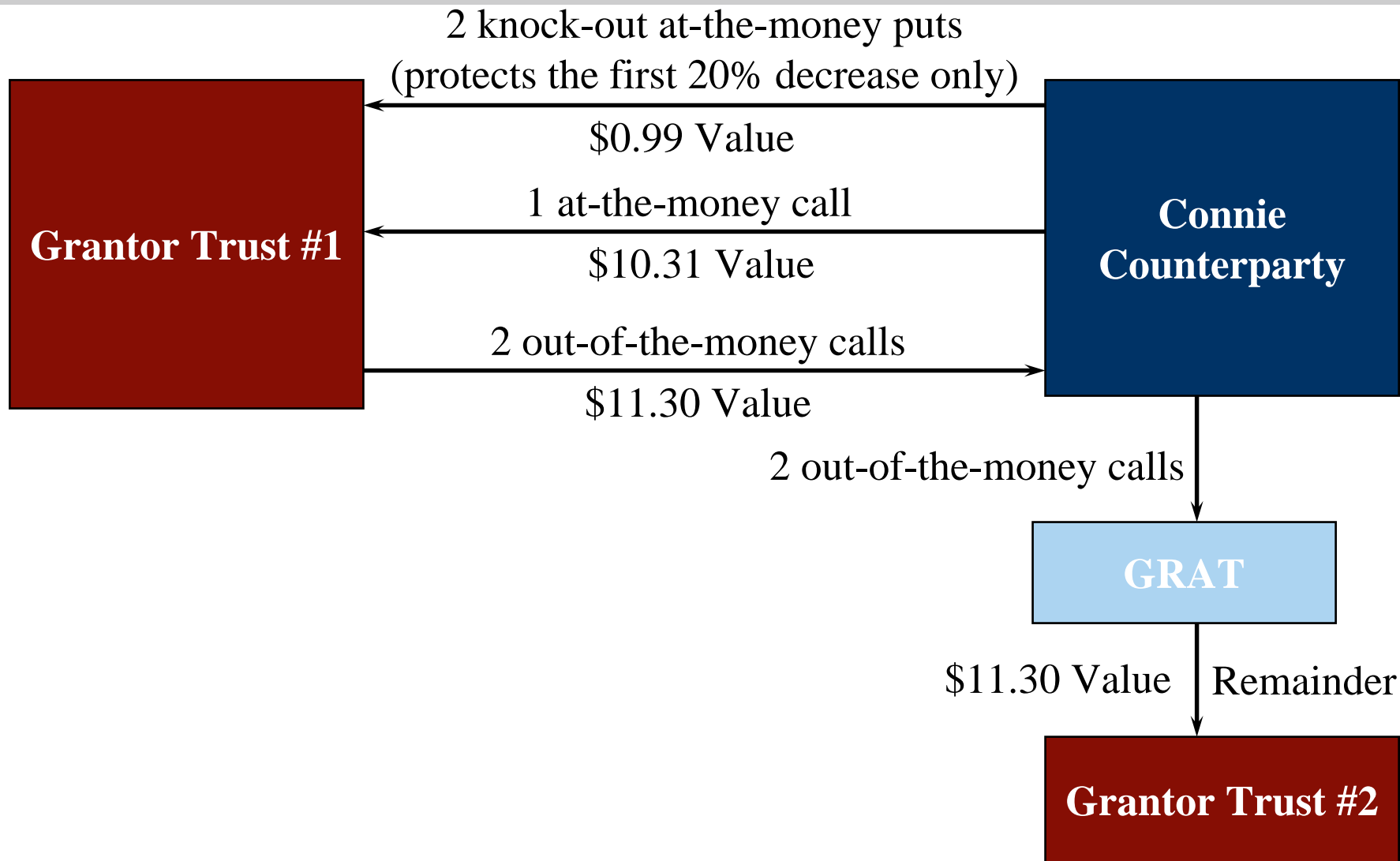
The ETF simulating the S&P 500 on March 2, 2009 is worth \$70.60. The sale of two out of the money call positions that are 13% above that \$70.60 price (or \$79.78) will bring to Tom \$11.30 for each share of the ETF. That \$11.30 can be redeployed to buy one at the money call, which is worth \$10.31 and two at the money knock out puts, which will protect the first 20% of downside of the ETF (the downside knock out level is \$56.48). The knock out at the money puts will cost 99¢.

After Connie enters into the transaction with Tom, she decides to transfer her two out of the money call positions to a new GRAT. The GRAT could have as its remainderman a different grantor trust (Grantor Trust #2) with different provisions.

Twin-Win Derivative Strategy Explained

- This derivative strategy involves a “cashless” purchase of one at the money call and two modified at the money puts.
- The purchases are funded by a sale of two out of the money calls.
 - More specifically, two 13 month out of the money (13% above current market price) calls are sold.
 - The proceeds of that sale are used to purchase one 13 month at the money call and two 13 month at the money puts. However, the puts are designed to have no value if the ETF declines by more than 20%.

The Proposed Transaction With Connie Counterparty is Graphically Demonstrated Below



The Potential Outcomes of the Proposed Transaction With Connie Counterparty Are Shown In the Chart Below

Numeric Summary Comparison of Results from the Perspective of Connie Counterparty's Family

Status Quo with Grantor Trust Holding
One Share of ETF

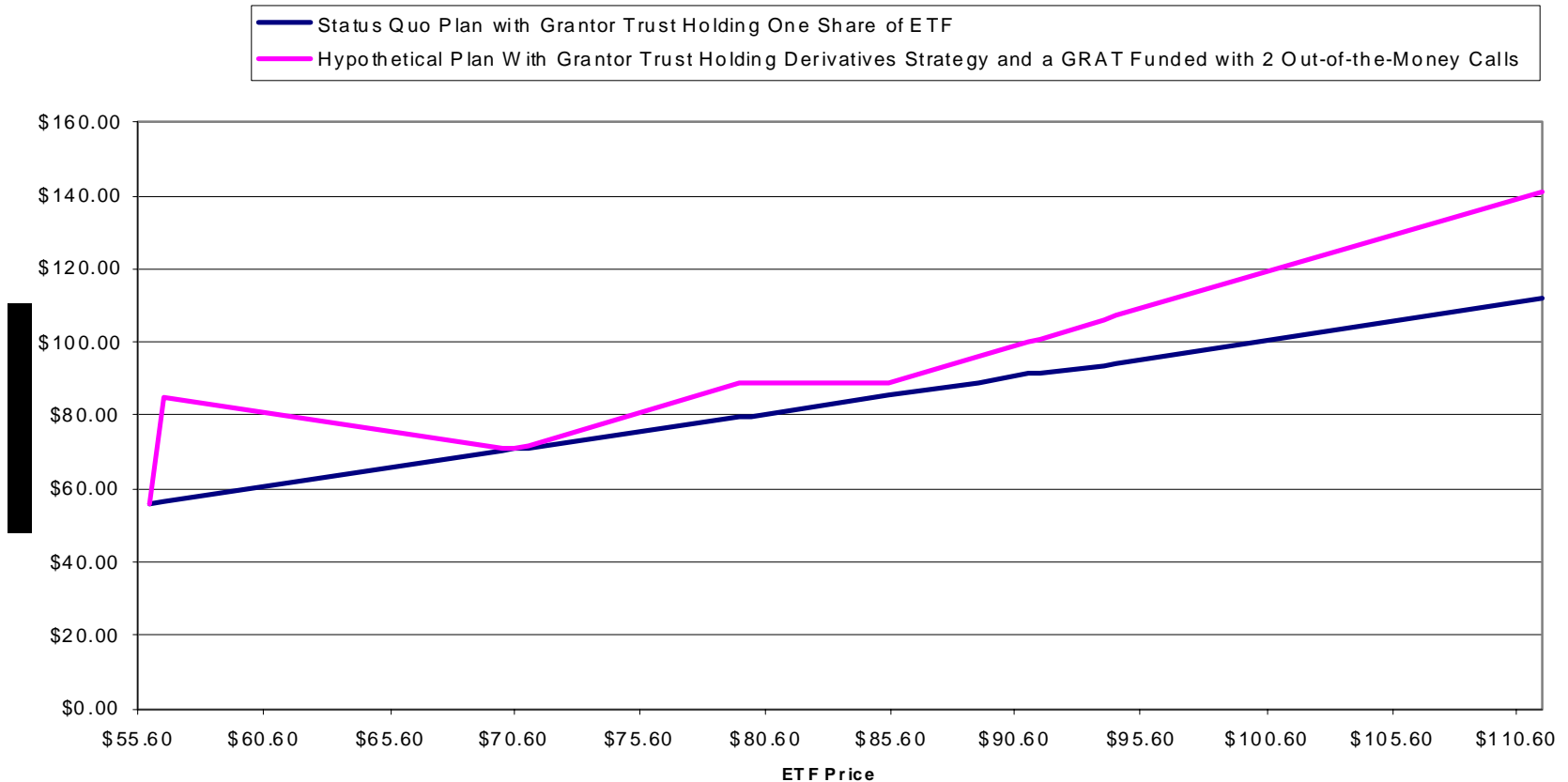
Hypothetical Plan With Grantor Trust Holding Derivatives
Strategy and a GRAT Funded with 2 Out-of-the-Money Calls

<u>Assumptions:</u>		<u>Estimated Profit/(Loss) Realized at the End of One Year</u>		<u>ESTIMATED TOTAL ASSETS TO BENEFICIARIES</u>		<u>Estimated Profit/(Loss) Realized at the End of One Year</u>		<u>Estimated Profit/(Loss) Realized at the End of One Year</u>		<u>ESTIMATED TOTAL ASSETS TO BENEFICIARIES</u>	
<u>Estimated ETF Value</u>	<u>Percentage Increase or Decrease in Value of ETF</u>	<u>Grantor Trust (Holding 1 Share of ETF)</u>	<u>Trust Total (\$)</u>	<u>Grantor Trust #1 (Derivatives Grantor Trust)</u>	<u>Grantor Trust #2 (2 OTM Call GRAT Beneficiary)</u>	<u>Trust Total (\$)</u>				<u>Trust Total (\$)</u>	
\$56.10	-20.54%	(\$14.50)	\$56.10	(\$14.50)	\$0.00	\$56.10				\$56.10	
\$56.60	-19.83%	(\$14.00)	\$56.60	\$14.00	\$0.00	\$84.60				\$84.60	
\$70.10	-0.71%	(\$0.50)	\$70.10	\$0.50	\$0.00	\$71.10				\$71.10	
\$70.60	0.00%	\$0.00	\$70.60	\$0.00	\$0.00	\$70.60				\$70.60	
\$71.10	0.71%	\$0.50	\$71.10	\$1.00	\$0.00	\$71.60				\$71.60	
\$79.60	12.75%	\$9.00	\$79.60	\$18.00	\$0.00	\$88.60				\$88.60	
\$80.10	13.46%	\$9.50	\$80.10	\$18.36	\$0.00	\$88.96				\$88.96	
\$85.60	21.25%	\$15.00	\$85.60	\$18.36	\$0.08	\$89.03				\$89.03	
\$89.10	26.20%	\$18.50	\$89.10	\$18.36	\$7.08	\$96.03				\$96.03	
\$91.10	29.04%	\$20.50	\$91.10	\$18.36	\$11.08	\$100.03				\$100.03	
\$91.60	29.75%	\$21.00	\$91.60	\$18.36	\$12.08	\$101.03				\$101.03	
\$94.10	33.29%	\$23.50	\$94.10	\$18.36	\$17.08	\$106.03				\$106.03	
\$94.60	33.99%	\$24.00	\$94.60	\$18.36	\$18.08	\$107.03				\$107.03	
\$111.60	58.07%	\$41.00	\$111.60	\$18.36	\$52.08	\$141.03				\$141.03	

* This derivative strategy involves a "cashless" purchase of one at the money call and two modified at the money puts. The purchases are funded by a sale of two out of the money calls. More specifically, two 53 week out of the money (13% above current market price) calls are sold. The proceeds of that sale are used to purchase one 53 week at the money call and two 53 week at the money puts. However, the puts are designed to have no value if the stock declines by more than 20%.

The Potential Outcomes of the Proposed Transaction With Connie Counterparty Are Shown In the Diagram Below

Graphic Summary Comparison of Results from the Perspective of Connie Counterparty's Family



This material is based on the assumptions stated herein. In the event any of the assumptions used do not prove to be true, results are likely to vary substantially from the examples shown herein. These examples are for illustrative purposes only and no representation is being made that any client will or is likely to achieve the results shown. Simulated, modeled, or hypothetical performance results have certain inherent limitations. Simulated results are hypothetical and do not represent actual trading, and thus may not reflect material economic and market factors, such as liquidity constraints, that may have had an impact on actual decision-making. Simulated results are also achieved through retroactive application of a model designed with the benefit of hindsight.

Best Family Limited Partnership Idea – Sell It (Pages 53 through 84)

Conventional Wisdom:

- “Do not engage in family limited partnership planning unless it can be demonstrated that the partnership uniquely solves a substantive non-tax problem;” or
- “Discounting a client’s assets is a much better estate planning tool than grantor trusts or freezing a client’s estate.”

This “conventional wisdom,” under the circumstances discussed below, is incorrect.

Example: The Sweet Deal

Cal Client is in his office when Dan Deal knocks on his door and tells Cal that he has “a heck of a deal for him.” Dan states that he would like to sell most of his assets to Cal for 65¢ on the dollar. Cal tells Dan that he likes the price, but he does not want to buy any of the assets for cash. Cal wonders if Dan would still be willing to sell his assets for 65¢ on the dollar, if it was all for a seller financed note from Cal. Dan tells Cal that because he likes him so much he will be happy to accept a note from Cal. Cal then informs Dan that while he likes the 65¢ on the dollar, he likes the fact that he can buy all the assets for a seller financed note, he does not like to pay much interest on the note and wonders if Dan will still offer that deal if the interest rates are comparable to US Treasury interest rates. Again, Dan tells Cal that because he likes him so much he will be happy to do that deal. Cal then informs Dan that while he likes the price of 65¢ on the dollar, and he also likes the fact that he can purchase the assets for a seller financed note at US Treasury interest rates, he will only buy the assets if he will have no personal liability on the note (i.e., the note will be non-recourse). Dan, once again agrees to Cal demands. An increasingly impatient Dan asks Cal if there are any other deal points. Cal says there is just one more. Cal tells Dan that he does not like paying income taxes. Cal will only do the deal if Dan will agree to pay all of the income taxes associated with the assets he is purchasing from Dan. Dan agrees.

If a Sale of a Partnership Interest Occurs During a Client's Lifetime, the Gift Tax Equivalent of I.R.C. Section 2036 Does Not Exist (i.e., There is No I.R.C. Section 2536 Under Chapter 12 of the Code)

Example: Lacy Lucky Sells Her Partnership Interest During Her Lifetime

Lacy Lucky lives in the great state of Nirvana. In the state of Nirvana, plaintiff's lawyers have been banned. In this enlightened state, wealthier spouses always receive all of the marital assets, if there is a failed marriage. Because this state is so enlightened, the SEC is very impressed and has waived its qualified purchaser and accredited investor rules with respect to trusts created under this state's laws. Because of all of these reasons (and because all children in this state are born with above average intelligence), Lacy Lucky is worried that a substantive non-tax reason may not exist for the creation of her family limited partnership. After the creation of the partnership, Lacy will own a 1% general partnership interest and a 98% limited partnership interest. Lacy asks her attorney, Tom Taxadvisor, what she could do to avoid the application of I.R.C. Section 2036(a)(1) other than avoiding behavior that might constitute an implied agreement to use the partnership asset income?

- Tom may advise Lacy to sell all of her limited partnership interest for adequate and full consideration.
- Even if the sale is not for adequate and full consideration (e.g. part sale, part gift or all a gift), if Lacy lives longer than three years after the transfer, then I.R.C. Section 2036(a)(1) should not apply to the resulting note (assuming the note is a note for state law property purposes) and/or cash she receives from that sale.

Best Family Limited Partnership Idea – Sell It (Pages 53 through 84 of the Paper)

- If a sale of a partnership interest occurs during a client's lifetime the gift tax equivalent of IRC Section 2036 may not exist.
- The valuation principles of Revenue Ruling 93-12 apply to lifetime transfers, but they do not apply to transfers at death.
- Growth of the underlying assets of the partnership, if a transfer occurs during the lifetime of a taxpayer, will not be subject to estate tax.
- A future Congress could change the current law with respect to valuation discounts associated with family limited partnerships.
- The taxpayer may have the ability to indirectly access all of the partnership distributable cash flow for consumption needs.
- Generally, the sale of a family limited partnership interest to a trust, is a flexible arrangement that can be modified to changed circumstances.
- The sale of a limited partnership interest for a note facilitates testamentary charitable planning, because the note is a more attractive asset for a charity to receive than family limited partnerships interests.
- There is a significant transfer tax advantage for the taxpayer who transfers his partnership interests during his lifetime to a grantor trust in exchange for a note.

Best Family Limited Partnership Idea – Sell It (Continued)

Example: Mimi Minimum Wonders What Additional Transfer Tax Benefit Accrues From a Partnership Valuation Discount Over Her Life Expectancy

Mimi Minimum is a very healthy 50 year old female. Both of her parents are still alive and she has only recently buried her grandparents. Her doctor assures her that she easily has a 30 year life expectancy. Mimi likes the relative simplicity of making a \$2,000,000 gift of some of her highly appreciated stock to fund a grantor trust and then selling her highly appreciated stock worth \$18,000,000 to that grantor trust for a low interest note after the sale for the note is completed, the grantor trust would then sell all \$20,000,000 of its stock (“Technique One” below). Mimi asks her estate planner, Les Rates what is gained by transferring a family limited partnership (which holds \$18,000,000 of her stock) to a grantor trust from a transfer tax standpoint, assuming she does live a 30 year period (“Technique Two” below). Mimi is concerned about the costs of creating a family limited partnership (legal costs, accounting costs, administrative costs and valuation expert costs). Mimi tells Les Rates to assume that she will earn 8% pretax return with respect to the proceeds of the sale of the appreciated stock (with 2% being taxed at ordinary income rates and 6% being taxed at capital gains rates with a 30% turnover) and that her consumption needs will be \$350,000 a year before inflation. What does Les Rates’ analysis demonstrate?

Summary of Results For \$20 Million of Asset With “0” Basis Growing at 8% Per Year (Pre-Tax) – No Further Planning vs. Two Hypothetical Integrated Income and Estate Tax Plans; 30 Year Future Values; Post-Death Scenarios (assuming client dies in 30 years)

Technique	Minimum Family	Consumption – Direct Cost	Consumption – Investment Opportunity Cost	IRS– Income Tax	IRS– Investment Opportunity Cost	IRS– Estate Tax (at 45%)	Total
No Further Planning; Bequeaths Estate To Family (Without Discount)	\$38,798,412	\$16,651,395	\$36,796,365	\$19,551,445	\$57,711,366	\$31,744,155	\$201,253,138
No Further Planning; Bequeaths Estate To Family (With Discount)	\$49,908,866	\$16,651,395	\$36,796,365	\$19,551,445	\$57,711,366	\$20,633,701	\$201,253,138
Technique #1: Hypothetical Integrated Income and Estate Tax Plan With a Gift/Sale to a GST; Bequeaths Estate To Family	\$68,269,192	\$16,651,395	\$36,796,365	\$21,308,079	\$57,711,366	\$516,740	\$201,253,138
Technique #2: Hypothetical Integrated Income and Estate Tax Plan With a Partnership and With a Gift/Sale to a GST; Bequeaths Estate To Family	\$68,399,886	\$16,651,395	\$36,796,365	\$21,796,365	\$57,711,366	\$298,954	\$201,253,138

Summary of Results For \$20 Million of Asset With “0” Basis Growing at 8% Per Year (Pre-Tax) – No Further Planning vs. Two Hypothetical Integrated Income and Estate Tax Plans; 10 Year Future Values; Post-Death Scenarios (assuming client dies in 10 years)

Technique	Minimum Family	Consumption-Direct Cost	Consumption Investment Opportunity Cost	IRS– Income Tax	IRS– Investment Opportunity Cost	IRS– Estate Tax (at 45%)	Total
No Further Planning; Bequeaths Estate To Family (Without Discount)	\$14,857,342	\$4,012,358	\$1,692,703	\$6,076,989	\$4,383,101	\$12,156,007	\$43,178,500
No Further Planning; Bequeaths Estate To Family (With Discount)	\$19,111,945	\$4,012,358	\$1,692,703	\$6,076,989	\$4,383,101	\$7,901,405	\$43,178,500
Technique #1: Hypothetical Integrated Income and Estate Tax Plan With a Gift/Sale to a GST; Bequeaths Estate To Family	\$20,869,217	\$4,012,358	\$1,692,703	\$6,780,213	\$4,383,101	\$5,440,909	\$43,178,500
Technique #2: Hypothetical Integrated Income and Estate Tax Plan With a Partnership and With a Gift/Sale to a GST; Bequeaths Estate To Family	\$23,931,861	\$4,012,358	\$1,692,703	\$6,635,610	\$4,383,101	\$2,522,868	\$43,178,500

Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Pages 84 through 122 of the Paper)

Conventional Wisdom:

- “The IRS will always contest the valuation of a family limited partnership interest because the IRS could increase the transfer taxes, if they can demonstrate that the valuation discount is too high;”
- “All valuation clauses in an assignment document are against public policy.”

This “conventional wisdom,” under the circumstances discussed below, is incorrect.

Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

Certain conclusions that may be drawn from the *Christainsen* and *McCord* cases:

- These cases strongly suggests that the Tax Court would be prepared to allow defined value formula clauses, with a gift over to entities or trusts other than charities, which incorporated the phrase “as finally determined for federal gift tax purposes.”
- The addition of the phrase “as finally determined for federal gift tax purposes” was obviously found to be an unnecessary addition by the Fifth Circuit. There may be key reasons why a donor, in his assignment document, would not wish to add that phrase. One reason is a practical one: over ten years is too long to wait to find out the result of whom own what in assignment of a closely enterprise (the facts of *McCord*). Another reason may be a tactical one: an arms-length transaction is the best evidence of value.
- It should be noted that in *King v. United States*, 545 F.2d 700 (10th Cir. 1976), the Tenth Circuit also found that *Proctor* did not apply where the transaction did not contain “contingencies which, upon fruition, alter, change or destroy the nature of the transaction.” While the facts are different in *Christiansen* and *McCord*, the value of the transfer to the McCord family was unaffected by any determination by any court or by the IRS.

Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

- Besides a public charity, the recipient of the “give over” in the defined value formula could be a spouse, marital deduction trust or grantor retained annuity trust (GRAT).
- Defined value clauses could cause practical problems as to the administration of the transferred property before a final determination has been made as to the portion of the property that has actually been transferred. For instance, issues may arise as to the distribution of income earned on the transferred property, the exercise of ownership rights and the reporting of the income for income tax purposes.
- Generally, these issues could be avoided by using a trustee as the transferee of the legal title to the property. The defined value clause could be a clause internal to the trust document creating the trust and could direct that the trustee is to allocate the interest in the hard to value asset between two trusts in which the trustee is the trustee. One trust could be held for the benefit of the client’s family and the other trust is held in a manner that is not subject to gift tax. In a similar fashion perhaps an escrow agent could also be utilized.
- In order to avoid certain income tax reporting uncertainties it is recommended that all of the “transferee” trusts be considered potentially defective grantor trust.

Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

Transfer to a GRAT:

- Valuation advantage of a GRAT
 - Under the regulations, the grantor's retained annuity rights may be defined in the trust instrument as a percentage of the fair market value of the property contributed by the grantor to the trust, *as such value is finally determined for federal tax purposes*. For example, the trust agreement might provide for payments of 53% per year for two years, where the 53% annual payment amount is derived from the initial value. This type of language operates as a built-in revaluation clause, mitigating the risk of a surprise gift on revaluation of the transferred property by the Service.
- If a GRAT is Not Administered Properly, the Retained Interest By the Grantor May Not Be Deemed to Be a Qualified Interest
 - The *Atkinson* worry: The U.S. Court of Appeals for the Eleventh Circuit (*see Atkinson*, 309 F.3rd 1290 (11th Cir. 2002), cert denied, 540 U.S. 945)), has held that an inter vivos charitable remainder annuity trust's (CRAT's) failure to comply with the required annual payment regulations during the donor's lifetime resulted in complete loss of the charitable deduction. The Court found that the trust in question was not properly operated as a CRAT from its creation. Even though the subject CRAT prohibited the offending acts of administration, the Court held that the CRAT fails.

Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

- In a similar fashion, the Internal Revenue Service could take the position that if the regulations under IRC Section 2702 are violated by the trustee of the GRAT's administrative practices, then the retained interest by the grantor will not be a qualified interest.
- Paying the grantor in satisfaction of his retained annuity interest with hard to value assets may disqualify his retained interest from being a qualified interest, if the assets are valued improperly.
 - In order to have a successful GRAT, it is obviously desirable to have an asset that has significant potential for appreciation. It is desirable from a volatility and potential growth standpoint to contribute, in many instances, a hard to value asset to the GRAT.
 - The problem with a GRAT that owns hard to value volatile assets is that when it is time to pay the retained annuity amounts to the grantor, it is often difficult to value the asset that is being used to satisfy the annuity obligation.

Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

- If the distributed asset is finally determined to be valued too low when it is used to satisfy the annuity amount owed by the GRAT, it could be deemed to be an additional contribution by the annuitant to the GRAT, which is prohibited. *See* Treas. Reg. Sec. 25.2702-3(b)(5).
- If it is finally determined that the hard to value asset that is distributed in satisfaction of the annuity payment to the grantor is over valued, it could be determined by the IRS that such a payment is a (pre-payment) commutation, which is also prohibited. *See* Treas. Reg. Sec. 25.2702-3(d)(5).
- Thus, the trustee of the GRAT, which is frequently also the grantor, must be very careful, like Goldilocks, to make sure that the annuity payments are “just right”. Using hard to value assets, to make the “just right” payments, may be highly problematic.
- The retained annuity interest is valued using the valuation principles under IRC Section 7520.

Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

- One of the disadvantages of a GRAT in comparison to sales to intentionally defective grantor trusts is that the qualified interest is valued under IRC Section 7520 (“Statutory Rate”), which is inherently higher than AFR that may be used for notes received for sales to intentionally defective grantor trusts.
- Possible structural planning solutions to lower the leverage cost of a GRAT and to also avoid paying the retained annuity with hard- to value assets.
- A possible solution to both of these potential disadvantages of using the GRAT technique is to consider contributing previously mortgaged limited partnership units to a GRAT.

Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

Example: Use of GRAT With Mortgaged Property

Grant Gratuitous approaches his attorney, Lenny Leverage and tells him that he would like to transfer, through the use of a GRAT, the maximum amount that he can transfer using a three year GRAT to his children. Grant Gratuitous tells Lenny Leverage that he has around \$30,000,000 in financial assets. Grant is willing to have about one-third of his assets subject to the GRAT technique.

Lenny likes many of the aspects of a GRAT, including its built-in revaluation clause. Lenny also likes using family limited partnerships because of the substantive nontax investment reasons that are sometimes associated with partnerships and because of the possibility of valuation discounts with family limited partnerships. Lenny particularly likes in today's credit markets the use of a family limited partnership with preferred partnership units.

Despite the advantages of GRATs and the possibility of valuation discounts of family limited partnerships, Lenny feels that there are certain disadvantages with contributing partnership units to a GRAT in comparison to a sale of partnership units to a grantor trust, including the disadvantage of the higher Statutory Rate and the potential difficulties in paying the retained annuity amounts in a GRAT with hard to value partnership units.

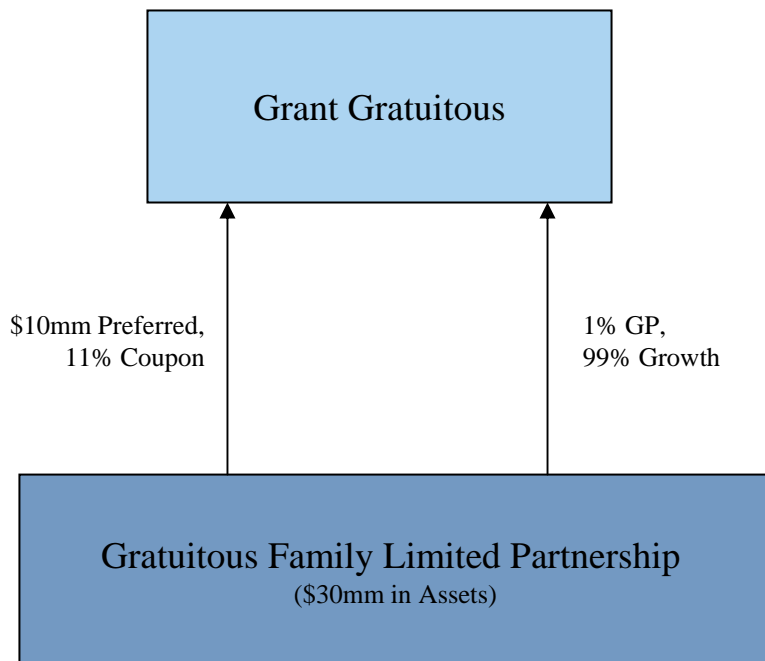
Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

Lenny suggests that Grant consider structuring the transaction using partnership interests that have been previously mortgaged and contributing the mortgaged partnership units to a GRAT. Lenny would also like to compare the results that would be obtained using a two class partnership (with preferred and growth interests) and a simple pro rata partnership.

Grant and Lenny assume the pro rata partnership will distribute 3% of the value of its assets to its partners. Grant and Lenny assume the partnership assets will grow at an 8% return pre-tax. They assume that a preferred partnership interest will pay an 11% dividend. The 8% return will be taxed at 3% ordinary income rate and 5% long term capital gains rates (with a 30% turnover). Grant and Lenny assume that the annual interest rate on a three year intra-family note is .69% (i.e., the short term AFR) and on a nine year intra-family note is 2.45% (i.e., the mid-term AFR) . Grant and Lenny assume that the Statutory Rate for a GRAT is 3.2%. Grant and Lenny assume the pro rata partnership discount is 35%.

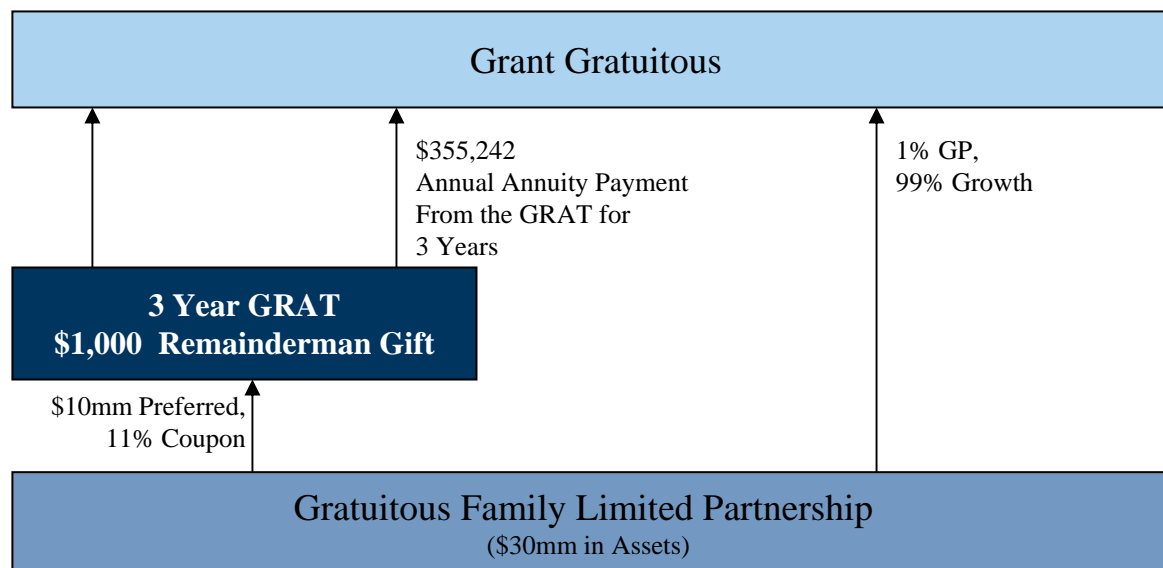
Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

- Use of a mortgage preferred partnership interest with a three year GRAT.
- Grant Gratuitous could create a family limited partnership or a family limited liability company that has a structure similar to the structure illustrated below (Scenario 1):



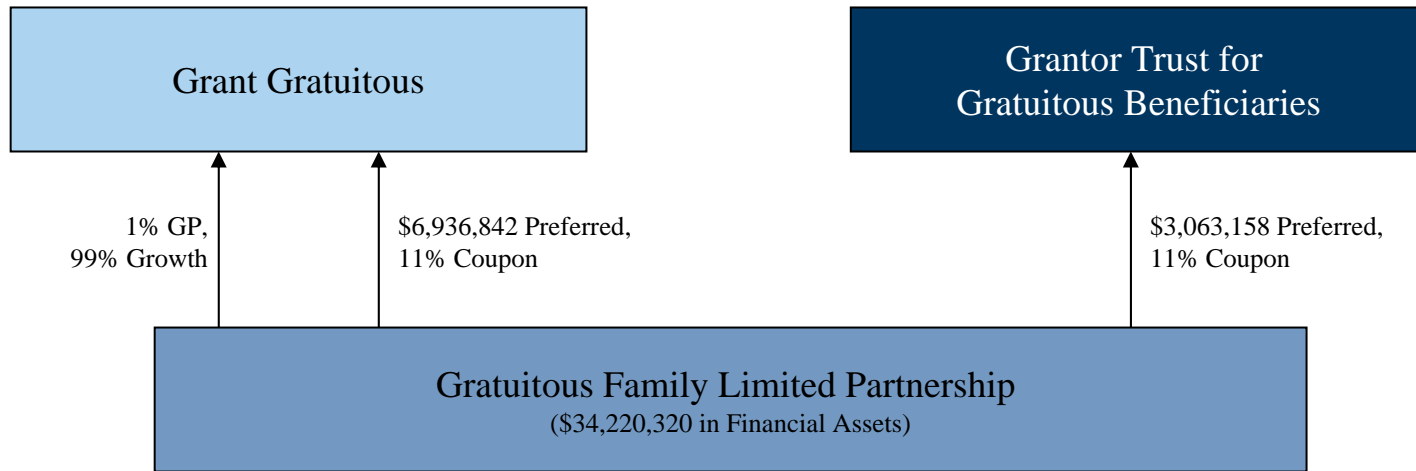
Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

- Scenario 1, Transaction 2 is illustrated below:



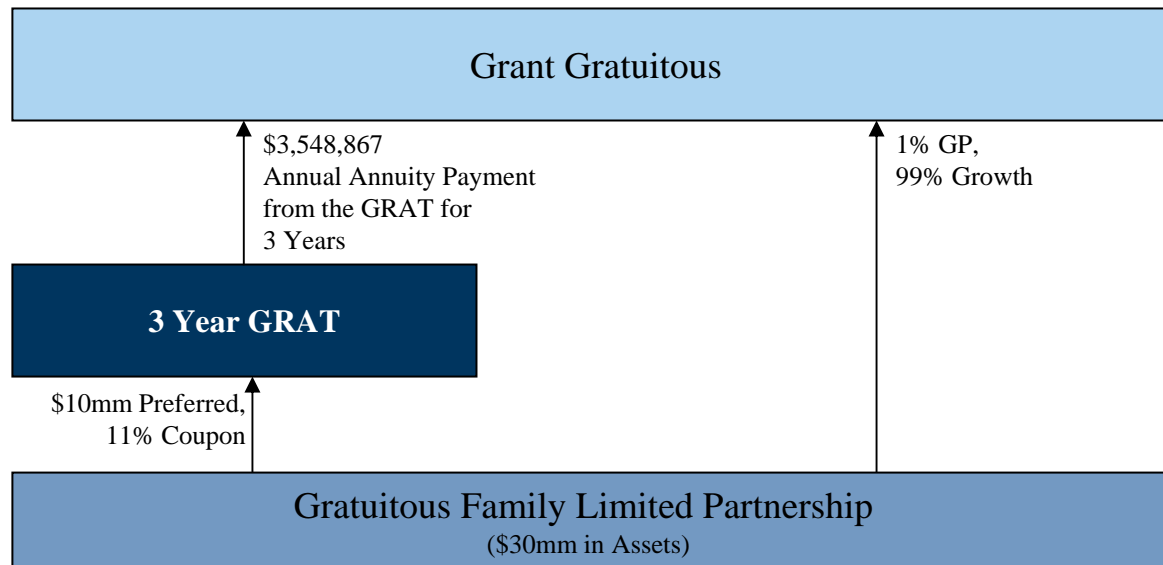
Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

- At the end of three years, under the above assumptions, \$3,063,158 of the preferred interests would have been transferred to the remainder beneficiaries of the GRAT that Grant created, as illustrated below:



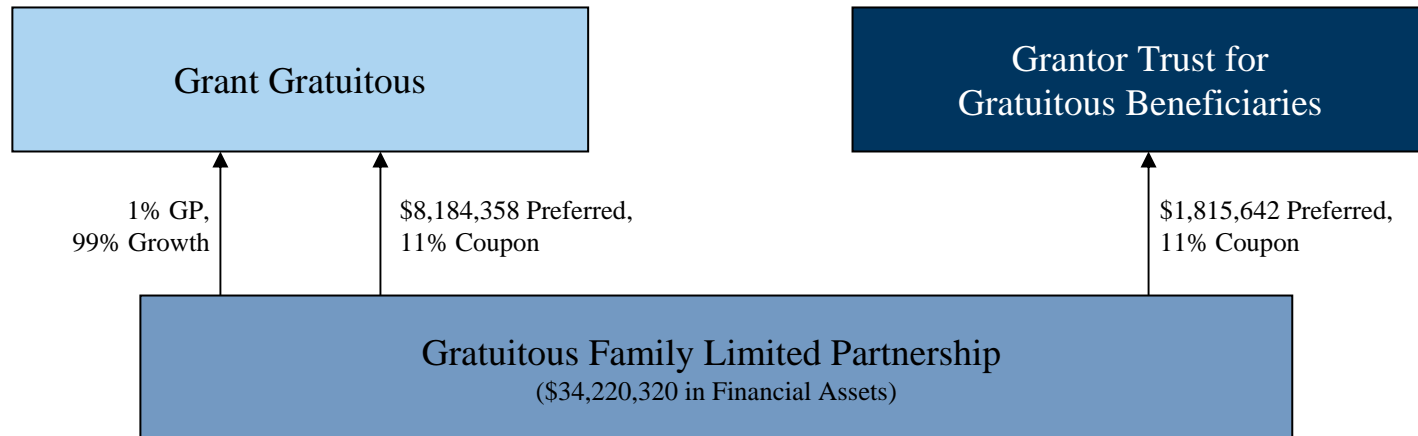
Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

- Lenny also compares what would happen if Grant contributes \$10,000,000 preferred to a GRAT without first mortgaging the preferred. If the preferred interest was simply contributed to a GRAT, the transaction would be similar to the illustration below (Scenario 2):



Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

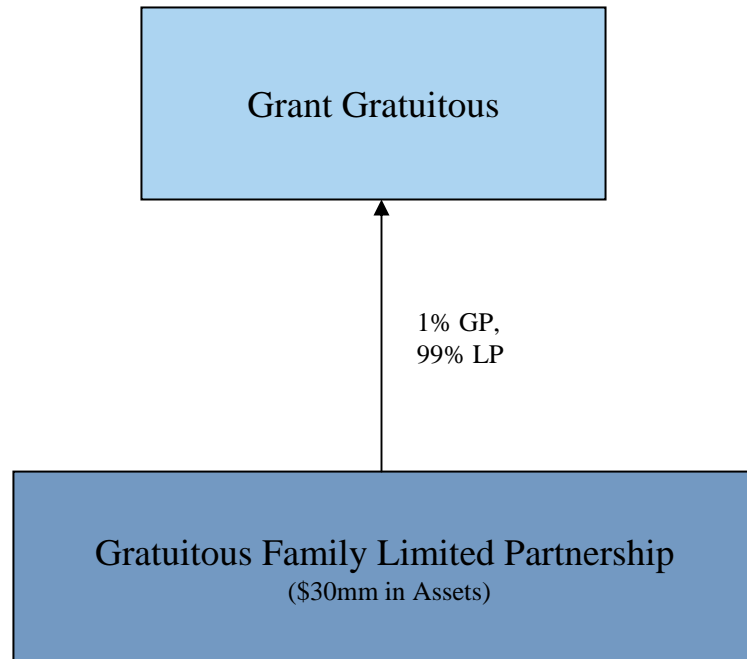
- At the end of three years, under the above assumptions, \$1,815,642 of the preferred interests would have been transferred to the remainder beneficiaries of the GRAT, as illustrated below:



- Obviously, the use of leverage substantially improves the result of the GRAT and also avoids having to pay the annuity with hard to value assets.

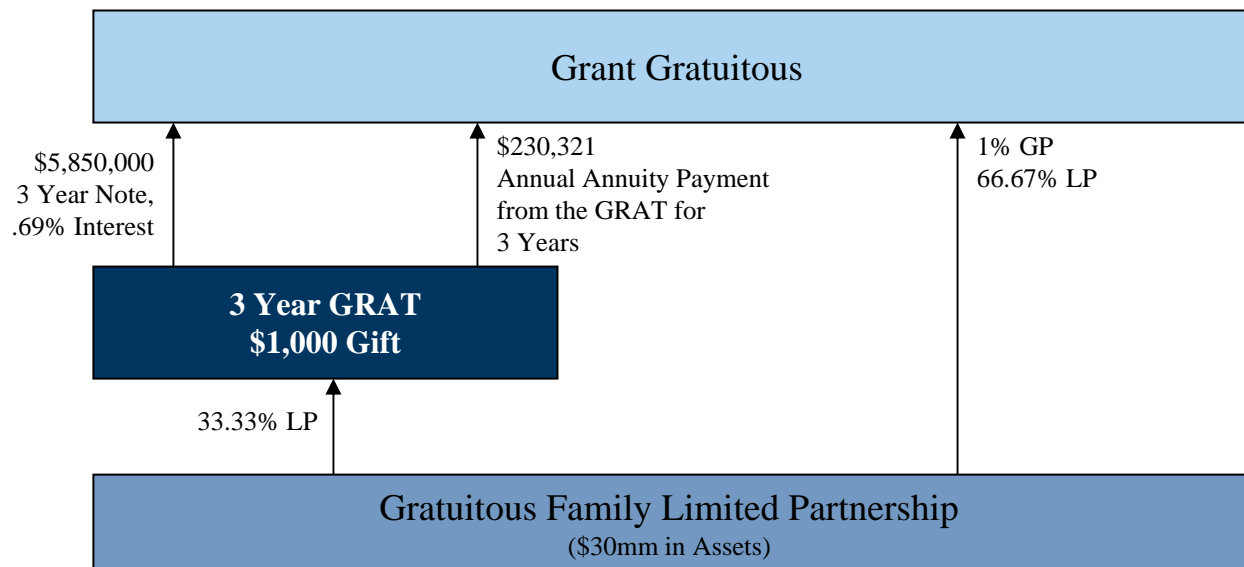
Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

- Lenny would also like to compare the two tiered partnership of using preferred and growth interests with a simpler structure of using a pro rata partnership or a pro rata limited liability company. See the illustration below:



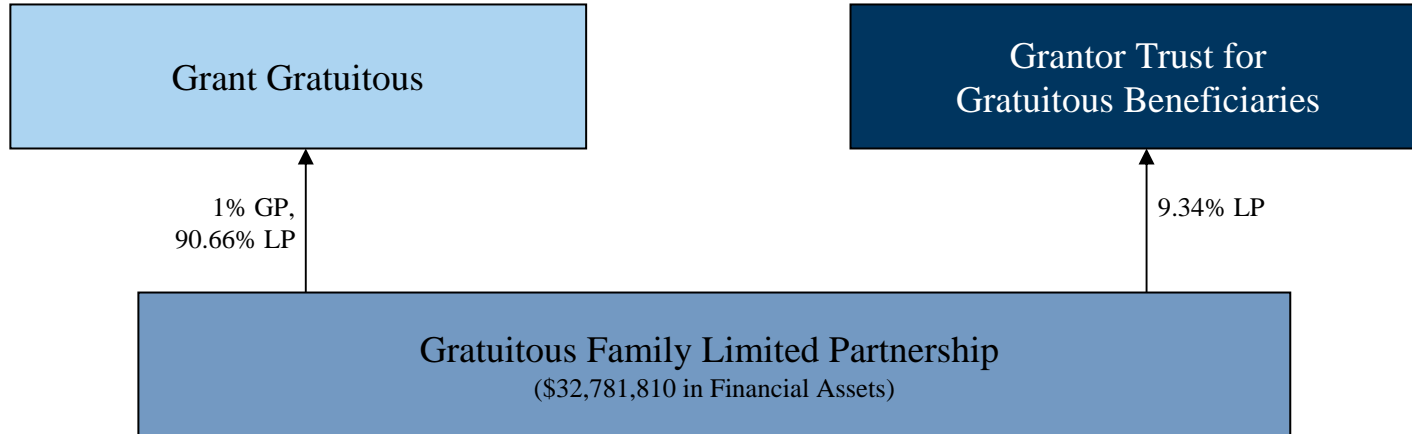
Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

- Again, assuming Grant would like to maximize the benefits of a GRAT in transferring one-third of his financial assets (which represent \$10,000,000) of partnership assets on a liquidation basis) to the proposed GRAT, Lenny suggests a structure in which a family limited partnership is created and then one-third of the partnership units are first gifted and/or sold, using 90% leverage, to a revocable trust. After all assignments have been completed, the revocable trust is amended by Grant to make it an irrevocable three year GRAT that is a near zeroed out GRAT. The transaction is illustrated below (Scenario 3):



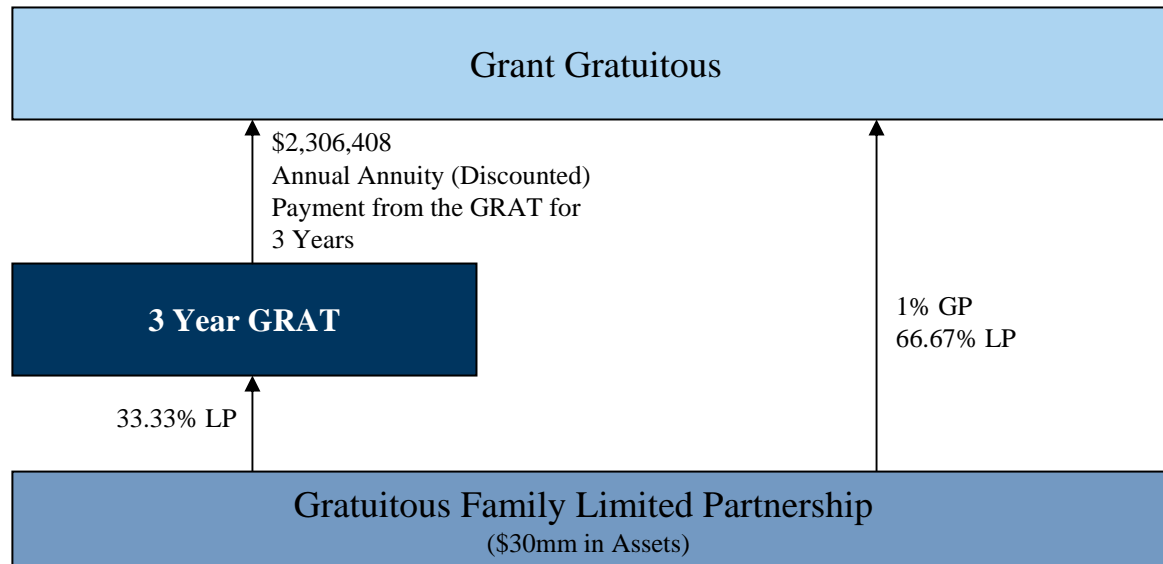
Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

- Three years later, under the assumptions noted above, 9.34% of the limited partnership interest would be owned by the remainder beneficiaries, as illustrated below:



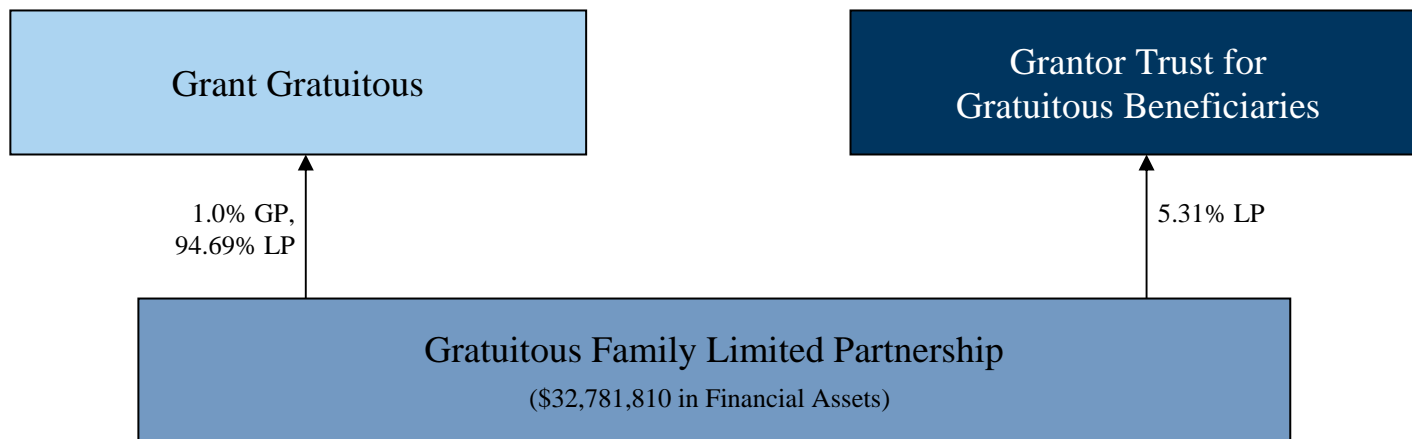
Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

- Finally, Lenny wishes to illustrate to Grant what the transaction would be like without any leverage. Thus, a 33.33% pro rata limited partnership interest is contributed to a GRAT in a transaction similar to the illustration below (Scenario 4):



Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

- At the end of three years, under the above assumptions, 5.31% of the limited partnership interest will be transferred to the remainderman beneficiaries of the trust as illustrated below (see Schedule 11):



Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

- Certain observations:
- When mortgaged partnership units are contributed to a GRAT, under the assumptions above, there is enough cash flow coming out of the partnerships, whether it is pro rata partnership units contributed to the GRAT or a preferred interest to pay all of the GRAT the annuity amounts during the Annuity Period in cash.
- This eliminates the problems associated with satisfying the GRAT annuity with hard to value assets.
- The notes associated with the mortgage before the GRAT is created will be finally satisfied with hard to value assets.
- However, the use of payments in kind to satisfy the loan does not run the “deemed contribution” danger that may be inherent in satisfying annuity payments with hard to value assets.

Best Valuation Idea For Family Limited Partnership Interests – The Defined Value Formula Gift (Continued)

- As the chart below illustrates, not only is the technique more structurally conservative, as far as preserving qualified interest status of a GRAT, the technique of using a mortgaged interest also has the desirable effect of significantly increasing the “estate planning” success of the GRAT (a 69% to 76% improvement under the investment assumptions of this example):

Comparison of Various Partnership Scenarios in which Partnership Units with a Liquidation Value of \$10mm are Transferred to a GRAT	Grant Gratuitous	Grantor Trust for Beneficiaries	Estimated Income Taxes	Estimated Gift Taxes	Estimated Total
Scenario #1: Creation of a 90% Mortgaged Preferred with the Contribution of the Mortgaged Preferred to a 3-Year GRAT	\$32,986,814	\$3,063,158	(\$1,619,136)	\$0	\$34,430,837
Scenario #2: The Contribution of the Preferred to a GRAT Without Any Leverage	\$34,234,331	\$1,815,642	(\$1,619,136)	\$0	\$34,430,837
Scenario #3: Creation of a 90% Mortgaged 33.33% Pro-Rata Partnership Interest, with the Contribution of the Mortgaged Pro-Rata Partnership Interest to a GRAT	\$32,988,260	\$3,061,712	(\$1,619,136)	\$0	\$34,430,837
Scenario #4: The Contribution of the 33.33% Interest in a Pro-Rata Partnership to a GRAT Without Any Leverage	\$34,310,798	\$1,739,174	(\$1,619,136)	\$0	\$34,430,837

- The reason for the substantial improvement is two-fold: (i) significantly increased leverage and (ii) the average hurdle rate “cost” of that leverage is below 1% (instead of the Statutory Rate).

Best GST Planning Idea – The Possible Use of a Leveraged GRAT (Pages 123 through 136 of the Paper)

Conventional Wisdom:

- “The remainderman of a GRAT cannot be a generation-skipping trust;”
or
- “You can use the leverage of a GRAT for gift tax purposes, but you cannot use that leverage for generation-skipping tax purposes.”

This “conventional wisdom,” under the circumstances discussed below, is incorrect.

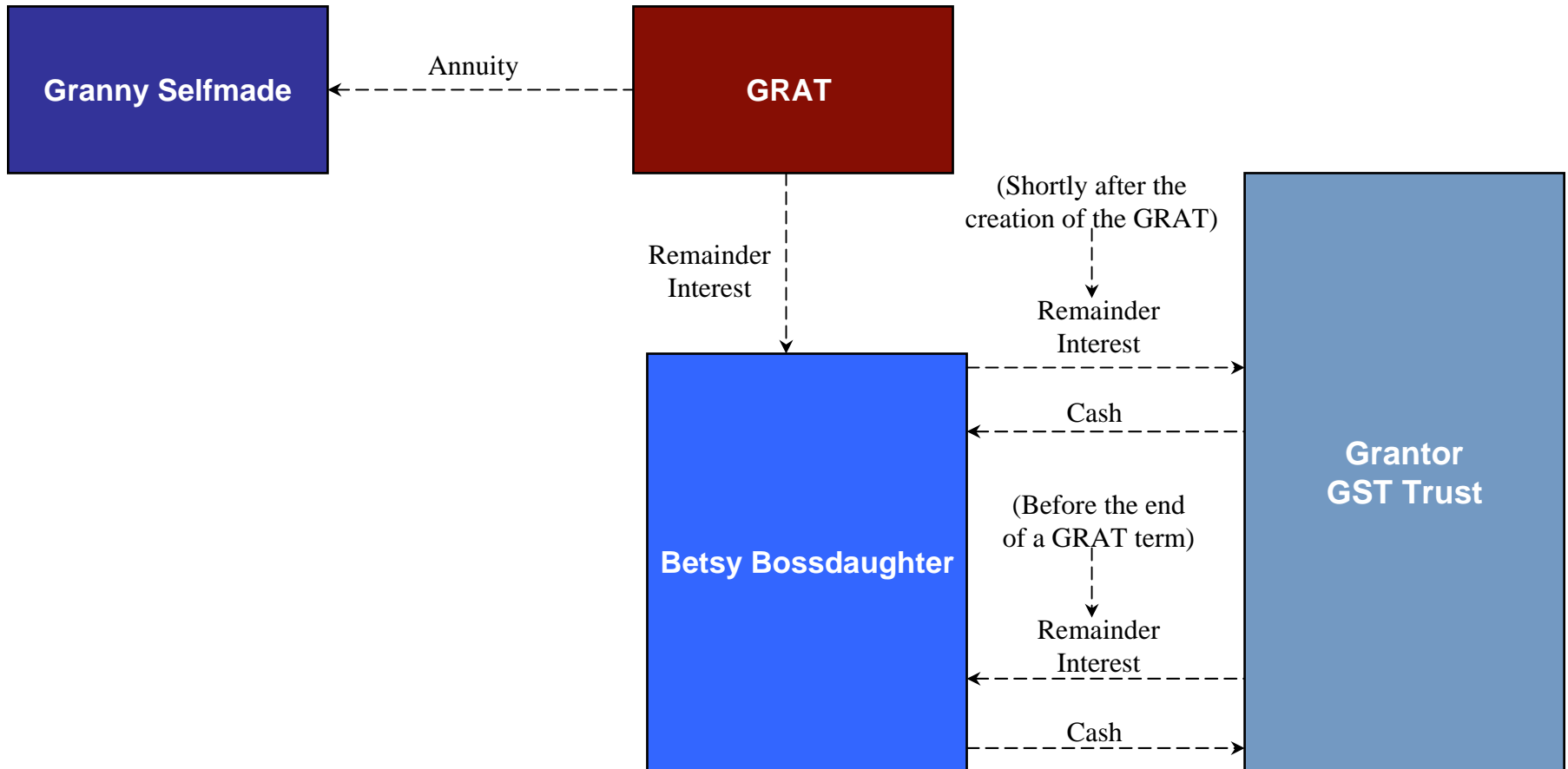
Is There a 5% Exception?

- Treas. Reg. Section 26.2632-1(c)(2) contains the regulatory definition of ETIP and then provides an exception, as follows:

For purposes of paragraph (c)(2) of this section, the value of transferred property is not considered as being subject to inclusion in the gross estate of the transferor or the spouse of the transferor if the possibility that the property will be included is so remote as to be negligible. A possibility is so remote as to be negligible if it can be ascertained by actuarial standards that there is less than a 5 percent probability that the property will be included in the gross estate.

- For a short term GRAT (e.g., two years), except for a grantor who is above 67 years of age, the 5% exception noted above would apply.
- At least one way of reading the exception for a short term GRAT is that the ETIP rules will not apply to an allocation of GST exemption, because there is less than a 5% chance that the grantor will die during the GRAT term.
- Thus, can a grantor, age 67 or younger create a GRAT in which the remainderman is GST trust, if the exception applies, make an allocation of the GST exemption that is equal to the amount of the taxable gift of the GRAT remainder, and produce a zero inclusion ratio for generation-skipping tax purposes?
- There is not any definitive authority on this subject, but most commentators believe the IRS will resist this result.

Example: Using the Leverage of a GRAT to Indirectly Profit a GST Trust – Non-Skip Person Exception



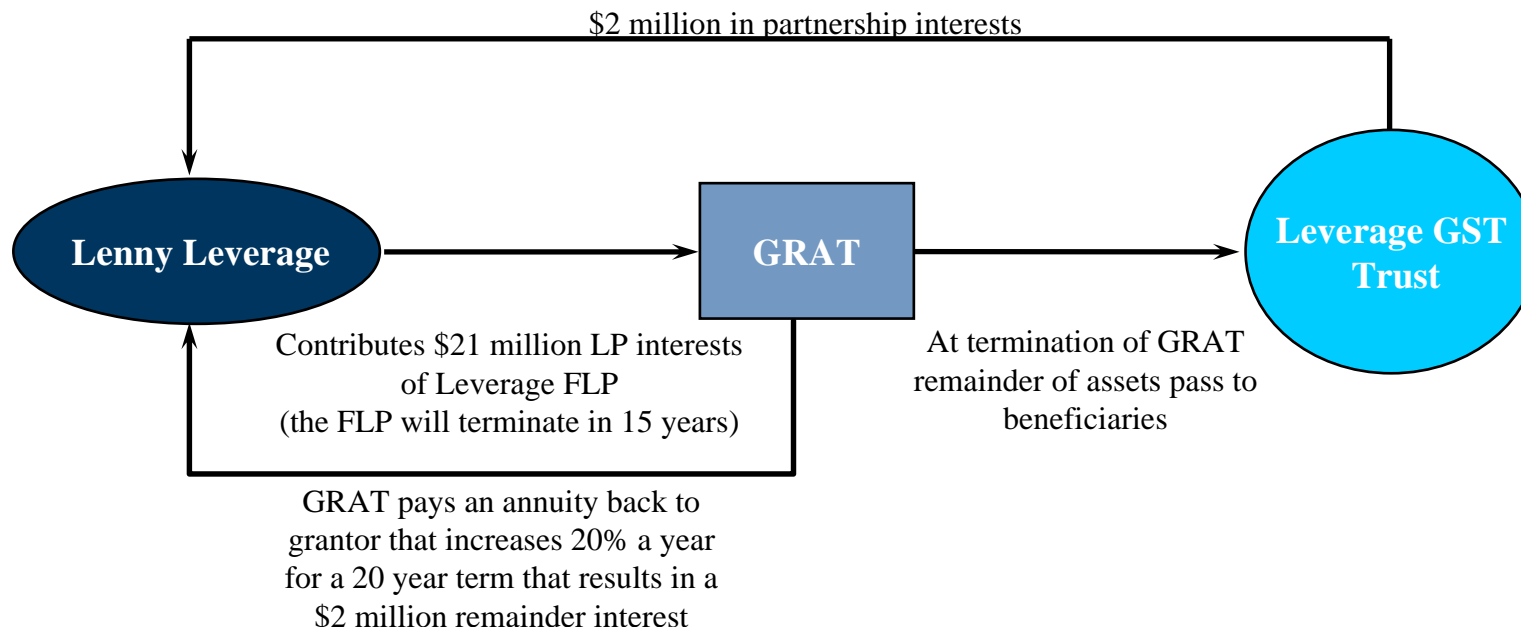
Using the Leverage of a GRAT to Indirectly Profit a GST Trust – Non-Skip Person Exception

- See private letter ruling 20010705. The private letter ruling’s basic holding can be viewed as uniquely applicable to the charitable lead annuity trust. However, it is clear that the IRS will look for other opportunities to apply equitable doctrines in similar contexts. Stated differently, the ruling’s reasoning could apply just as easily to a GRAT, if the reader substituted the phrase “ETIP rules” for “I.R.C. Section 2642(e).”
- Using the same logic, the Service could find that a gift of a GRAT remainderman is avoidance of the Congressional intent in enacting the ETIP rules. However, would the equitable doctrines inherent in the ruling apply to a sale by Betsy? It would appear that the answer should be no.
- In using a sale for full and adequate consideration, the issue is not whether Granny or Betsy is the transferor of the property that moves from the GRAT to the dynasty trust. The issue is whether there is an addition to the dynasty trust for GST purposes. There should not be an addition to the dynasty trust for GST purposes when Betsy transfers the remainder interest to the GST trust for full and adequate consideration and when Betsy buys the remainder interest back for full and adequate consideration.

Best GST Planning Idea – The Possible Use of a Leveraged GRAT (Continued)

- Consider a GRAT that is created with a substantial remainder interest, however, because of a purchase of a remainder interest of the GRAT, there is not a gift. That is, instead of making a gift of the remainder interest, what if the grantor of a GRAT sold it for full and adequate consideration to a pre-existing trust? IRC Section 2036 inclusion does not apply if the grantor dies before the GRAT term ends, and as a consequence, the ETIP limitation may also not apply and the creation of the GRAT may not constitute a transfer to the GST trust.

The technique is illustrated below:



Best GST Planning Idea – The Possible Use of a Leveraged GRAT (Continued)

Please note the table below, which delineates the amount that is projected to be transferred to Lenny’s children, grandchildren and great grandchildren pursuant to this technique in comparison to not doing any further planning with respect to the partnership. The table assumes Lenny’s death at the end of year 20, Lenny consumes \$100,000 a year with a 3% inflation rate, an 8% pre-tax rate of return with 2% being taxed at ordinary income rates (35%) and 6% at capital gains rates (15%, with a 30% turnover). The table assumes Lenny has \$1,500,000 of assets outside the partnership. Assume that the partnership, at the time of the creation of the purchase GRAT, has only 15 years remaining and that the valuation discount is 30%.

Technique	Leverage Children	Leverage GST Trust	Consumption – Direct Cost	Consumption – Investment Opportunity Cost	IRS – Income Tax	IRS – Investment Opportunity Cost	IRS – Estate Tax (at 45%)	Total
No Further Planning; Bequeaths Estate To Family	\$55,282,583	\$13,317,021	\$2,687,037	\$3,022,654	\$20,916,430	\$19,680,241	\$45,231,204	\$160,137,171
Hypothetical Integrated Income and Estate Tax Plan With a Partnership and GRAT; Bequeaths Estate To Family	\$9,687,257	\$98,772,116	\$2,687,037	\$3,022,654	\$20,778,989	\$17,263,179	\$7,925,938	\$160,137,171

Best GST Planning Idea – The Possible Use of a Leveraged GRAT (Continued)

- The results are obviously very significant. Will this work? An argument can certainly be made that the creation of the purchase GRAT is not subject to the ETIP rules and the creation of the GRAT does not constitute a transfer to the GST trust. If Lenny died during the 20 year term of the GRAT, the GRAT property will not be includible in his gross estate, only the value of the remaining annuity payments would be included. Alternatively, the GRAT annuity period could be set for the shorter of 20 years or the death of Lenny. Obviously, the GRAT annuity payment would have to be set at a higher amount in order to provide adequate and full consideration to Lenny. If Lenny died earlier than 20 years there would be significant income tax and estate tax advantages in structuring the GRAT term in that manner.
- There could be abusive situations where the remainder interest is very small and the logic of the *Wheeler*, *D'Ambrosio* and *Magnin* cases would not be applied.
- However, under the facts assumed under this case, the remainder interest is significant and would seem to be analogous to the remainderman values considered in the above Circuit Court cases.

Best Post Mortem Planning Idea (and a Good Insurance Planning Idea) – The Note “Freeze” Partnership (Pages 136 through 150 of the Paper)

Conventional Wisdom:

- “Using a family limited partnership always creates administrative problems, it does not solve them;” or
- “Life insurance will be included in an insured’s estate if the insurance is owned by a partnership in which he is a partner.”

This “conventional wisdom,” under the circumstances discussed below, is incorrect.

Best Post Mortem Planning Idea (and a Good Insurance Planning Idea) – The Note “Freeze” Partnership (Continued)

Please consider the following example:

Connie Confused Wishes to Simplify Her Post-Mortem Administrative Life and Also Accomplish Some Estate Planning Goals

Carl Confused dies in a year in which the estate tax exemption and the GST exemption are \$2,000,000. Carl and Connie live in a community property state. The financial assets of their community property estate equal \$12,000,000. Carl and Connie, at Carl's death, have not created a family limited partnership. Connie is 70 years of age and is in very good health. Connie is the lifetime beneficiary of the by-pass trust, which is also a generation-skipping trust that Carl created under his will. Connie also wishes to create a generation-skipping trust using her \$1,000,000 gift tax exemption. In order to help defray the cost of paying estate taxes, Connie is contemplating purchasing a \$2,500,000 life insurance policy on her life that is a guaranteed universal life policy.

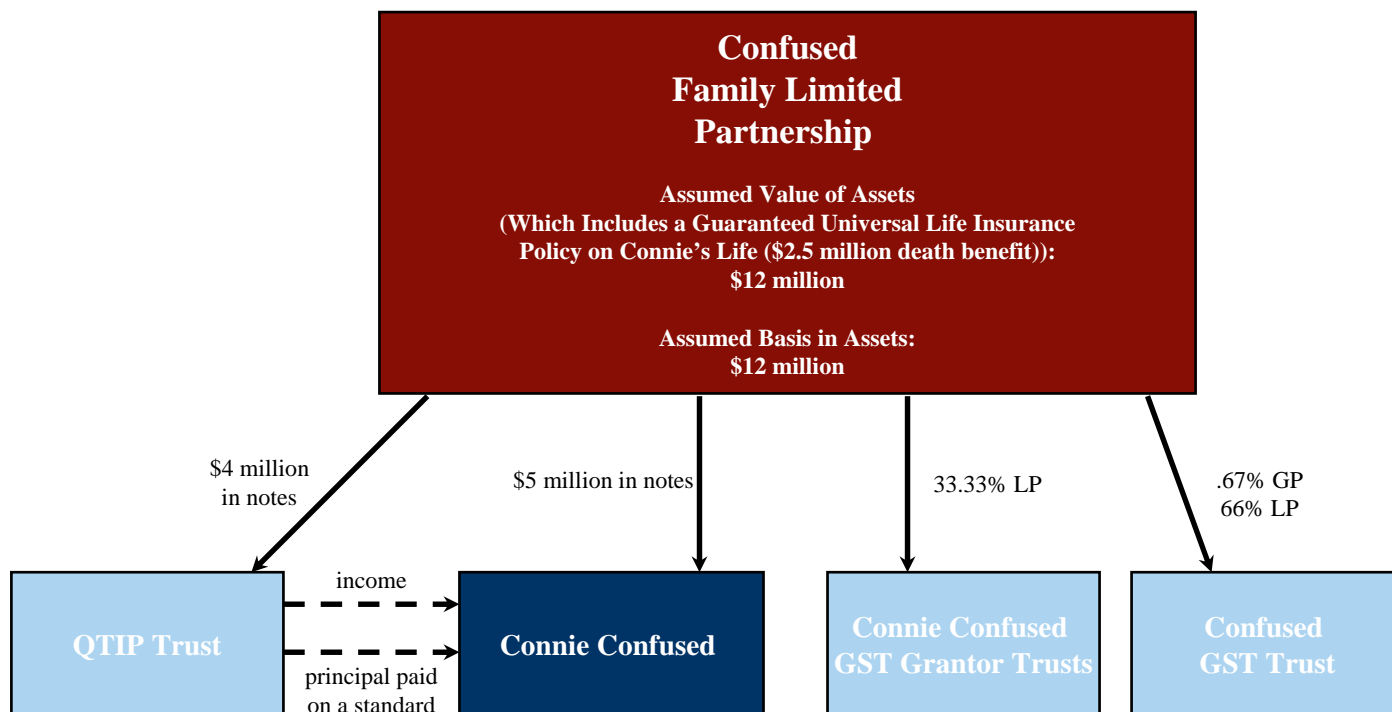
Connie asks her estate planner, Pam Planner, if there is any way to organize the multiple trusts and her financial assets where there is a simplified structure that consolidates the community estate assets and saves future estate taxes. She asks Pam to assume that she will spend \$250,000 a year, after income taxes, with a 3% inflation adjustment.

Best Post Mortem Planning Idea (and a Good Insurance Planning Idea) – The Note “Freeze” Partnership (Continued)

- Pam suggests that Connie and the various trusts form a partnership with the various parties either receiving a note for their contribution to the partnership or receiving partnership interests for their contribution to the partnership.
- The \$2,000,000 GST trust, in which Connie is a lifetime beneficiary, receives a partnership interest for its \$2,000,000 contribution. The \$1,000,000 GST trust that Connie creates will receive a partnership interest for its \$1,000,000 contribution. Connie receives a note for the contribution of her assets. The various QTIP trusts receive notes for their contribution to the partnership. The notes pay the AFR interest rate.

Best Post Mortem Planning Idea (and a Good Insurance Planning Idea) – The Note “Freeze” Partnership (Continued)

The diagram below illustrates the concept:



- Simplifies the administration of the estate.
- Takes advantage of the step-up in basis of estate assets.
- Life insurance proceeds will not be subject to I.R.C. Section 2042.
- Note freeze partnership is not subject to valuation rules of I.R.C. Section 2701.
- The historic low yields on treasuries accentuate the result of note freeze partnership.

Comparative Result of the Note Freeze Partnership

Please note the following table, which compares the result that would have accrued had Connie not done any further planning with the hypothetical plan (assuming she lives 20 years, consumes \$250,000 a year, after inflation) the family assets earn 8% before taxes, with 2% being taxed as ordinary income and 6% being taxed as capital gains rates with an assumed 30% turnover.

Technique	Confused Children	Confused GST Trust	Consumption – Direct Cost	Consumption – Investment Opportunity Cost	Investment Opportunity Cost/(Benefit) of Buying Life Insurance	IRS – Income Tax	IRS – Investment Opportunity Cost	IRS – Estate Tax (at 45%)	Total
No Further Planning; Bequeaths Estate To Family	\$14,538,178	\$7,041,630	\$6,717,594	\$7,556,636	\$0	\$5,569,070	\$5,477,142	\$9,031,236	\$55,931,486
Hypothetical Integrated Income and Estate Tax Plan With a Partnership; Bequeaths Estate To Family	\$3,701,671	\$25,629,169	\$6,717,594	\$7,556,636	\$377,325	\$5,777,962	\$5,187,944	\$983,185	\$55,931,486

Not only does the proposed structure greatly simplify the administration problems for Connie, but it also has the potential of saving considerable transfer taxes. If Connie should die early (e.g., in 5 years) the life insurance policy forms a substantial “hedge” against an early death.

Best Life-Time Charitable Planning Idea – Partnership, or a Limited Liability Company, Creates a Charitable Remainder Trust With the Partnership Units Eventually Being Sold to a Grantor Trust (Pages 151 through 162)

Conventional Wisdom:

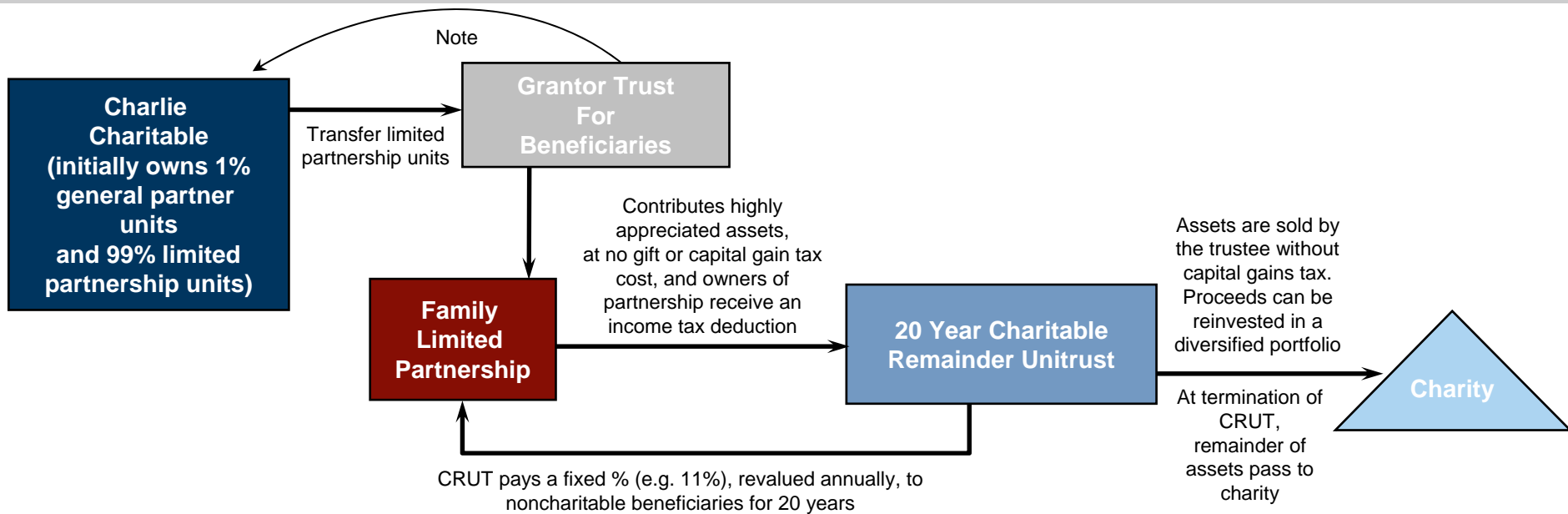
- “You can no longer use the CRUT technique and benefit your family;”
or
- “The problem with charitable planning is that it will greatly decrease what a client’s family will receive.”

This “conventional wisdom,” under the circumstances discussed below, is incorrect.

Best Lifetime Charitable Planning Idea – Partnership, or a Limited Liability Company, Creates a Charitable Remainder Trust With the Partnership Units Eventually Being Sold to a Grantor Trust (Continued)

- Charitable remainder trusts, particularly charitable remainder uni-trusts (“CRUTs”) are a very popular planning technique for the charitably inclined client. While the technique has significant benefits to the client and his favorite charitable causes, one downside is the perception that it is difficult to benefit a client’s family with the technique. Perhaps that is not true, if the technique is used synergistically with certain other estate planning techniques, that is, sale of limited liability company or limited partnership units to a grantor trust. What if that synergistic planning simulated a capital gains tax and estate tax holiday for the client and his family with the client’s family charity receiving 23% of his death on his death?

Best Lifetime Charitable Planning Idea – Partnership, or a Limited Liability Company, Creates a Charitable Remainder Trust With the Partnership Units Eventually Being Sold to a Grantor Trust (Continued)



Advantages
<ul style="list-style-type: none"> • Generation of current income tax deduction (10% or more of value placed in CRUT) • Depending on investment performance, approximately 40% to 60% of inherent capital gains in the asset contributed to the CRUT will not be subject to capital gains tax • The remaining inherent capital gains will be subject to tax, but is tax-deferred (over 20 years) • Production of relatively steady cash flow over time • Tax-efficient satisfaction of charitable desires • Economic participation in growth of assets

Considerations
<ul style="list-style-type: none"> • Limit on certain investment alternatives • Certain prohibited related-party transactions (even if fair) • In the early years, access to capital is limited • Capital gains tax rates may increase in the future • Administrative costs in connection with formation of partnership

The Comparative Results

To show Charlie the difference that taxes play in accumulating family wealth over time, Pam projects what would happen if there were no initial capital gains taxes when Charlie sells his stock and no estate taxes. She also projects what would happen if Charlie sold partnership interests to a grantor trust without including the CRUT component. If the investment plan produced smooth returns until Charlie's death (which the group agrees to project twenty-five into the future), the results would look like this:

Scenario	Charlie's Children	Charlie's Descendants (GST Exempt)	Charity	Charlie's Consumption Direct Costs	Consumption Investment Opportunity Costs	IRS – Income Taxes	IRS – Investment Opportunity Costs	IRS – Estate Taxes	Total
Stock Sale, No Planning	14,795,841	2,000,000	-	5,468,890	8,795,202	7,413,154	16,269,613	13,742,052	68,484,752
Simulated Tax Holiday (No Initial Capital Gains Tax and No Estate Tax) 72% - 28% Split Between Family and Charity	-	28,053,477	8,510,849	5,468,890	8,795,202	8,008,304	9,648,029	-	68,484,752
FLP/CRUT/ Grantor Trust Sale, Charlie gives remaining estate to charity	-	27,731,762	8,510,849	5,468,890	8,795,202	7,685,158	10,292,890	-	68,484,752
FLP/ Grantor Trust Sale, Charlie gives remaining estate to family	-	29,698,713	-	5,468,890	8,795,202	8,117,016	16,269,613	135,318	68,484,752

Best Testamentary Charitable Planning Idea For the Family Limited Partnership – The Leveraged Buy-Out Charitable Lead Annuity Trust

(Pages 162 through 168 of the Paper)

Conventional Wisdom:

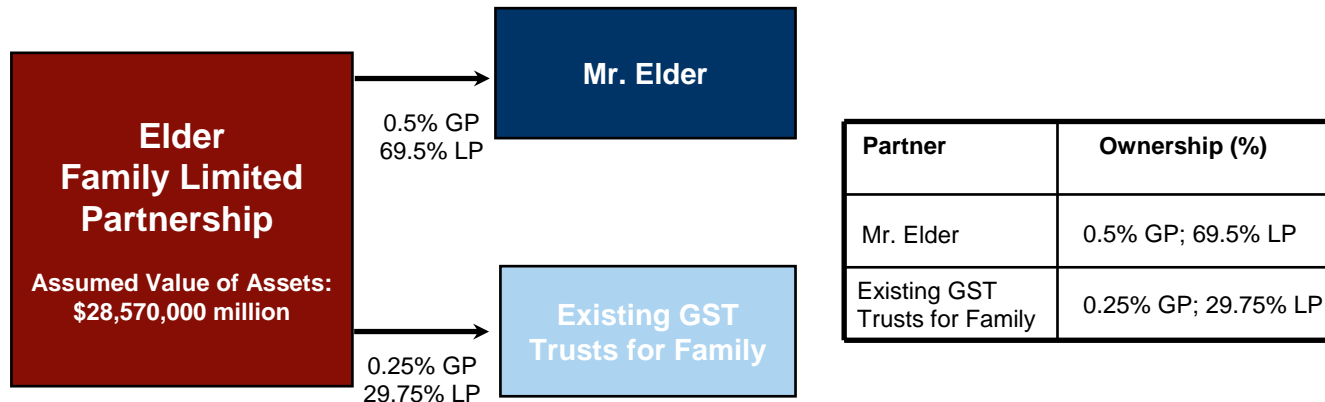
- “One can never self-deal, even on a fair basis, with a foundation or a CLAT;”
- “The problem with testamentary gifts to charity is that the decedent’s family always ends up with substantially less;” or
- “The problem with testamentary CLATs is that the decedent’s family has to wait a long time to have access to the decedent’s assets.”

This “conventional wisdom,” under the circumstances discussed below, is incorrect.

Best Testamentary Charitable Planning Idea For the Family Limited Partnership – The Leveraged Buy-Out Charitable Lead Annuity Trust (Continued)

- Assume a client, at his death, wishes for part of his estate to go to his family and the rest to his favorite charitable causes. One technique that is generally considered under those circumstances is the testamentary charitable lead annuity trust (“CLAT”):

During Ed’s lifetime he creates a partnership with his family:

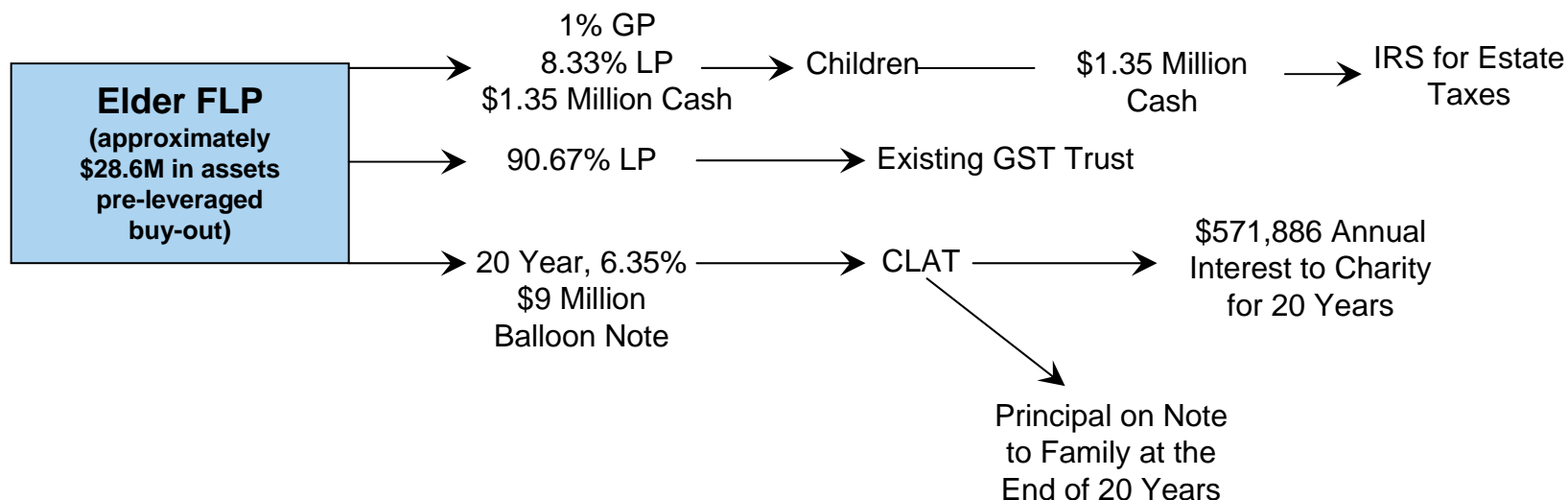


Best Testamentary Charitable Planning Idea For the Family Limited Partnership – The Leveraged Buy-Out Charitable Lead Annuity Trust (Continued)

After Ed’s death his will conveys his partnership interest as follows:



After a probate hearing Ed’s testamentary CLAT is redeemed as follows:



What Are the Comparative Results of the Leveraged Buy-Out CLAT?

Summary of Results For \$28.57 Million of Assets Growing at 8% Per Year (Pre Tax) – No Further Planning vs. 20 Year Testamentary CLAT Technique; 30 Year Future Values; Post-Death Scenarios (assuming Mr. Elder dies in year 1)

Technique	Elder Children	Elder GST Trust	Charity	IRS – Income Tax	IRS- Investment Opportunity Cost	IRS- Estate Taxes	Total
No Further Planning Without a Discount 8%, 30 Years	74,723,823	55,481,827	-	29,497,788	118,801,049	9,000,000	287,504,487
No Further Planning With a Discount 8%, 30 Years	84,904,303	55,481,827	-	33,691,823	108,026,533	5,400,000	287,504,487
CLAT Redemption With a Discount and \$3 Million to Family 8%, 30 Years	46,374,710	92,379,335	56,500,420	30,013,402	60,886,619	1,350,000	287,504,487
CLAT Redemption With a Discount and \$10 Million to Family 8%, 30 Years	74,166,232	65,866,823	12,555,671	32,874,812	97,540,948	4,500,000	287,504,487

What Are the Comparative Results of the Leveraged Buy-Out CLAT? (Continued)

- The primary reason the leveraged buy out CLAT technique has a good result for both the client's family and the client's favorite charities, is that, in effect, the client's family is getting two tax deductions for the interest payments that they are making on the note. There is an estate tax deduction (i.e., the zeroed out CLAT annuity payments) and the family owners of the partnership are also receiving an income tax deduction on the interest payments.
- The secondary reason the technique has a good result for the family is that they are not out-of-pocket cash to pay the principal of the note to a third party.
- From the family's perspective, the principal of the note is, in effect, paid to themselves.
- From the family's perspective, they have the assets now subject to the interest obligations of the note held by the CLAT (which could be satisfied with a sinking fund of laddered bonds).

Best Insurance Planning Idea (and a Very Good Partnership Planning Idea) – The Leveraged Reverse Freeze With a Cascading Sale of Growth Partnership Interests (Pages 168 through 183 of the Paper)

Conventional Wisdom:

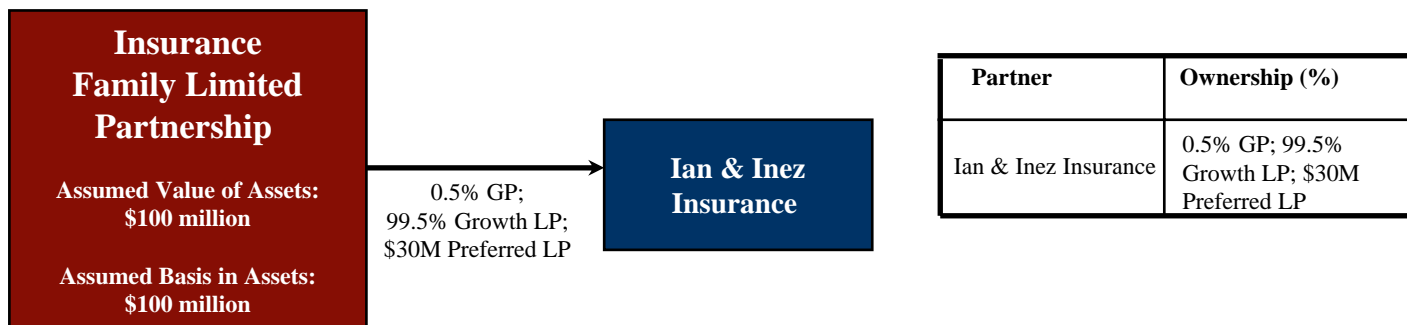
- “Using a preferred partnership interest is dead after the passage of I.R.C. Section 2701;” or
- “It is impossible, after the split dollar reform, for a trust to pay for premiums on a significant life insurance policy without paying significant gift taxes.”

This “conventional wisdom,” under the circumstances discussed below, is incorrect.

One of the somewhat unexplored areas of estate planning is the utilization of what some practitioners call “reverse freeze” planning. This planning takes advantage of the truism that investors have the potential of making a successful investment, if they engage in a leveraged purchase of a high yield preferred interest. The following idea exploits the current differentiation in yields between high yield fixed income and treasuries.

Best Insurance Planning Idea (and a Very Good Partnership Planning Idea) – The Leveraged Reverse Freeze With a Cascading Sale of Growth Partnership Interests (Continued)

- Consider the following example, which illustrates the potential of combining a leveraged sale of a high yielding preferred to a grantor trust with the trust using its excess cash flow to purchase life insurance and make cascading purchases of the growth partnership interests:

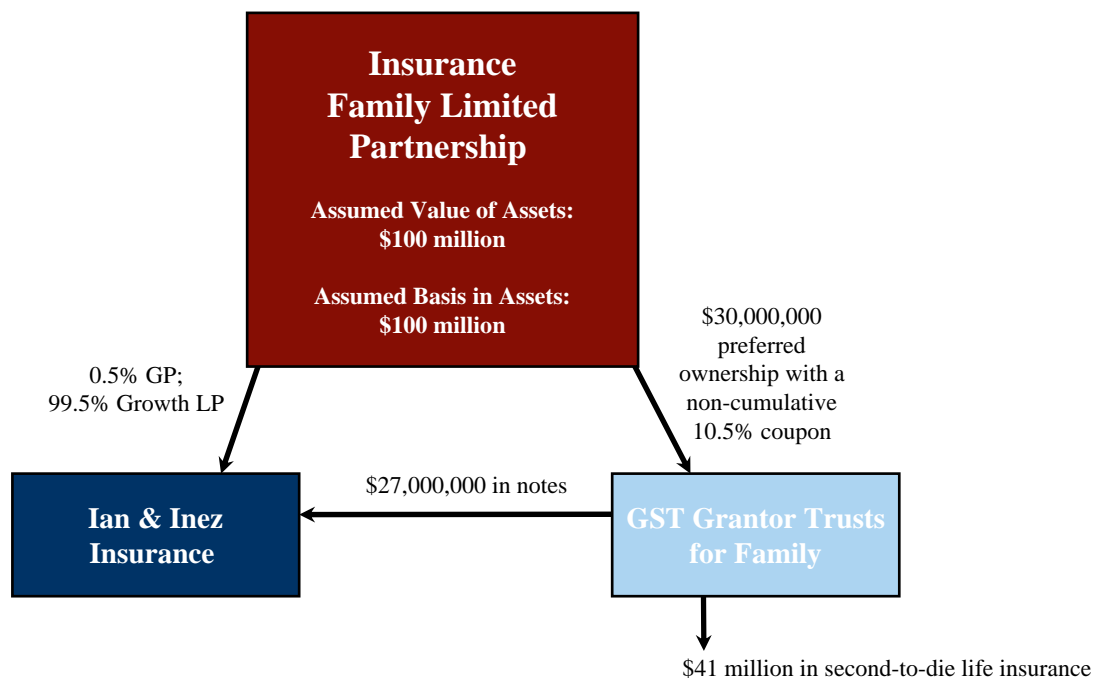


- After the partnership has been created Ian and Inez Insurance transfers, by gift, a \$3,000,000 preferred partnership interest with a non-cumulative 10.5% coupon to some generation-skipping transfer trusts for the benefit of their children, grandchildren and future descendants.

Best Insurance Planning Idea (and a Very Good Partnership Planning Idea) – The Leveraged Reverse Freeze With a Cascading Sale of Growth Partnership Interests (Continued)

- Ian and Inez also sell the remaining \$27,000,000 preferred interests to those trusts in exchange for notes that will pay a blended AFR rate of 2.06%.

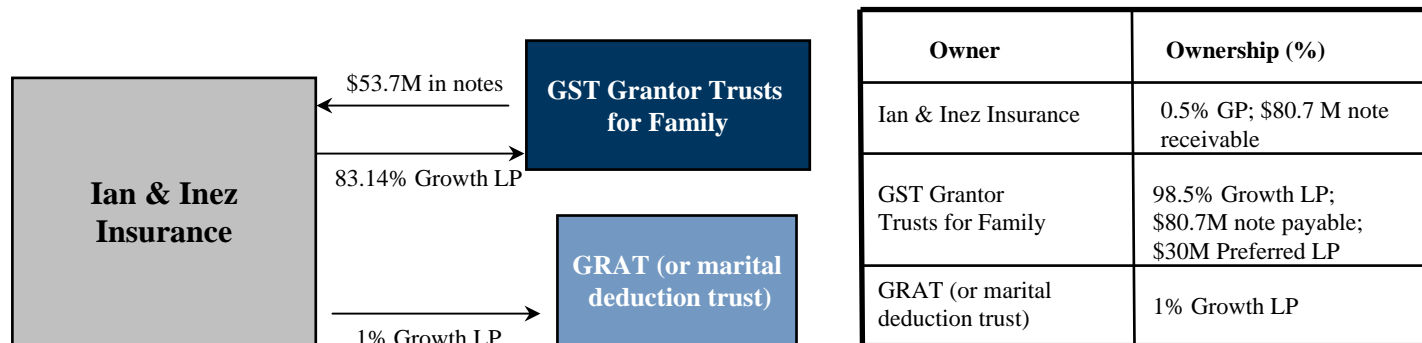
See the illustration below:



Best Insurance Planning Idea (and a Very Good Partnership Planning Idea) – The Leveraged Reverse Freeze With a Cascading Sale of Growth Partnership Interests (Continued)

- Approximately three years after the transfer of the preferred partnership interests, the GST grantor trust could purchase from Ian and Inez their remaining growth interests that have not been sold in prior years in exchange for notes (on which, it is again assumed there will be a blended 2.06% interest rate).
- During the interim three year period, it is assumed that around 16% of the growth limited partnership units will have been purchased. The purchase of the remaining growth interests could occur in a manner in which there is a defined value sale and in which a stated dollar amount (around \$54M) of the value of the transferred growth limited partnership interest, as finally determined for federal gift tax purposes, passes to the generation-skipping trusts and any excess in value passes to a near zero GRAT or a marital deduction trust.

See the illustration below:



Best Insurance Planning Idea (and a Very Good Partnership Planning Idea) – The Leveraged Reverse Freeze With a Cascading Sale of Growth Partnership Interests (Continued)

Advantages:

- With the use of life insurance, there is a hedge against early deaths.
- In Revenue Ruling 83-120 the IRS concedes preferred partnership interests in a closely held partnership should have a high coupon.
- Currently, there exists a significant arbitrage between high yielding private preferred partnership interests in a closely held partnership and treasury interest rates.
- Strong legislative history suggests I.R.C. Section 2036 should not apply to partnerships with significant preferred interests.
- The valuation rules of I.R.C. Section 2701 should not apply if one generation transfers its ownership of preferred partnership interests to the second generation.
- A later transfer of the growth partnership interests will not be affected by the valuation rules of I.R.C. Section 2701.

Best Insurance Planning Idea (and a Very Good Partnership Planning Idea) – The Leveraged Reverse Freeze With a Cascading Sale of Growth Partnership Interests (Continued)

The tables below indicate the results that could accrue under the assumptions given to Pam Planner by Ian and Inez and also assuming a \$400,000 a year premium and a 40% discount on the growth partnership interests (because of the effect of the preferred partnership interests). The results are extremely powerful. Assuming that Ian and Inez die in 10 years, the 30 year future values of the hypothetical integrated plan in comparison to not doing any further planning is as follows:

30 Year Future Values (Death in 10 Years)

Technique	Insurance Children	Insurance Children & Grandchildren	Consumption – Direct Cost	Consumption – Investment Opportunity Cost	IRS – Income Tax	IRS – Investment Opportunity Cost	IRS – Estate Tax (at 45%)	Investment Opportunity Cost/(Benefit) of Buying Life Insurance	Total
No Further Planning; Bequeaths Estate To Family	\$417,679,967	\$0	\$22,927,759	\$168,266,209	\$94,874,217	\$580,465,509	\$82,357,221	\$0	\$1,366,570,882
Hypothetical Integrated Income and Estate Tax Plan With a Partnership; Bequeaths Estate To Family	\$173,319,917	\$572,273,337	\$22,927,759	\$168,266,209	\$159,136,543	\$432,194,150	\$34,174,842	(\$195,721,874)	\$1,366,570,882

Best Insurance Planning Idea (and a Very Good Partnership Planning Idea) – The Leveraged Reverse Freeze With a Cascading Sale of Growth Partnership Interests (Continued)

If the survivor of Ian and Inez Insurance dies in 30 years, the future value in 30 years of what their descendants will receive under the hypothetical plan in comparison to no further planning is as follows:

Future Value (Death in 30 Years)

Technique	Insurance Children	Insurance Children & Grandchildren	Consumption – Direct Cost	Consumption – Investment Opportunity Cost	IRS – Income Tax	IRS – Investment Opportunity Cost	IRS – Estate Tax (at 45%)	Investment Opportunity Cost/(Benefit) of Buying Life Insurance	Total
No Further Planning; Bequeaths Estate To Family	\$337,941,016	\$0	\$95,150,831	\$266,196,369	\$124,662,541	\$266,122,930	\$276,497,195	\$0	\$1,366,570,882
Hypothetical Integrated Income and Estate Tax Plan With a Partnership; Bequeaths Estate To Family	\$7,205,005	\$586,008,373	\$95,150,831	\$266,196,369	\$133,704,220	\$258,888,064	\$5,895,004	\$13,523,015	\$1,366,570,882

The Use of the Reverse Freeze Technique Also Works Very Well With a GRAT That Has a Term of 10 Years or Longer

- In the above example, if Mr. and Mrs. Insurance created 10 year GRATs with \$30 million of the 10.5% coupon preferred partnership interests, and if the IRC Section 7520 rate is 2.8%, the gift for gift tax purposes would be only \$905,120.50 (assuming the preferred is worth \$30 million).
- In the above example, if Mr. and Mrs. Insurance created 11 year GRATs with \$30 million of the 10.5% coupon preferred partnership interests, and if the IRC Section 7520 rate is 2.8%, the gift for gift tax purposes would be only \$170,620 (assuming the preferred is worth \$30 million).

Best Ideas for Allowing a Client to Be in Control of a Family Limited Partnership in the Context of Section 2036(a)(2) – Rev. Rul. 73-143, 95-58 and 81-15

(Pages 183 through 195 of the Paper)

Conventional Wisdom:

- “A donating partner should never retain any type of management control of a FLP.” or
- “A donating partner may not have any input, directly or indirectly, on the distribution policy of a family limited partnership.”

This “conventional wisdom,” under the circumstances discussed below, is incorrect.

Best Ideas for Allowing a Client to Be in Control of a Family Limited Partnership in the Context of Section 2036(a)(2) – Rev. Rul. 73-143, 95-58 and 81-15 (Continued)

- In the *Strangi* case, some commentators believe Judge Cohen’s reliance on *O’Malley* is misplaced.
- Sell the partnership interests for full consideration.
- Use the same fiduciary constraints in the partnership as *Byrum*.
- Follow Rev. Rul. 73-143; See sample language (pages 159 to 160 of the paper).
- Follow Rev. Rul. 95-58.
- Follow Rev. Rul. 81-15.

Additional Information

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Date of Revision: February 2010