Partnership Freeze as an Alternative to a GRAT or SGT

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A Little Bit of History

- Prior to 1987, Common Estate Planning included:
  - Estate Freeze – Senior transferred future appreciation of business to junior but retained control of the business
    - Recapitalization into voting common, non-voting common, and preferred stock
    - Transferred almost all value to non-cumulative preferred stock
    - Transferred non-voting common with little value to junior
  - Grantor Retained Income Trust – Senior transferred property retaining an income interest (typically in non-income producing property) and reduced the gift value reported by a predetermined actuarial value of the income interest

A Little Bit of History

- The Revenue Act of 1987 attempted to limit this practice by modifying Internal Revenue Code (IRC) Section 2036(c)
- The Revenue Reconciliation Act of 1990 retroactively repealed the 1987 changes and added Chapter 14 (IRC Sections 2701 through 2704)
- These valuation rules remain the hurdles to transfer (estate/gift) planning today

Current Law

- IRC Section 2701 generally requires that for a gift of a partial interest in property to family members, any retained interest is to be valued at zero unless it meets the definition of a qualified payment
  - It details the roadmap for determining a qualified payment
  - The roadmap requires a junior equity interest to be at least 10% of the entity value to be considered a qualified interest (Sec. 2701(a)(4))
  - It also defines a qualified payment to include a cumulative preferred stock fixed rate dividend payable on a periodic basis (Sec. 2701(c)(3))

Current Law

- IRC Section 2702 modifies the valuation rules with respect to transfers of interests in trusts to family members
  - A retained income interest generally has a zero value
  - An exception applies for a "qualified interest" and is to be valued under IRC Section 7520 (See Sec. 2702(a)(2)(A))
  - A qualified interest is defined as an annuity or unitrust interest (such as in a Grantor Retained Annuity Trust) (Sec. 2702(b))
  - Another exception applies for an interest in a residence (Sec. 2702(a)(3)(A)(ii))
    - A Personal Residence Trust or
    - A Qualified Personal Residence Trust

Grantor Retained Annuity Trust (GRAT)

Overview

- A GRAT is a strategy that allows transfer of all appreciation above a discount rate set by IRS to family beneficiaries over a period of time
- Provides for income stream to grantor (annuity payments in cash or in kind) over a specified number of years
- Requires that the grantor survives the term of the GRAT, or, generally, the full market value of trust property is included in the estate of the grantor
- Serial GRATs with staggered maturities can be used to mitigate risk of death during the term of a single GRAT

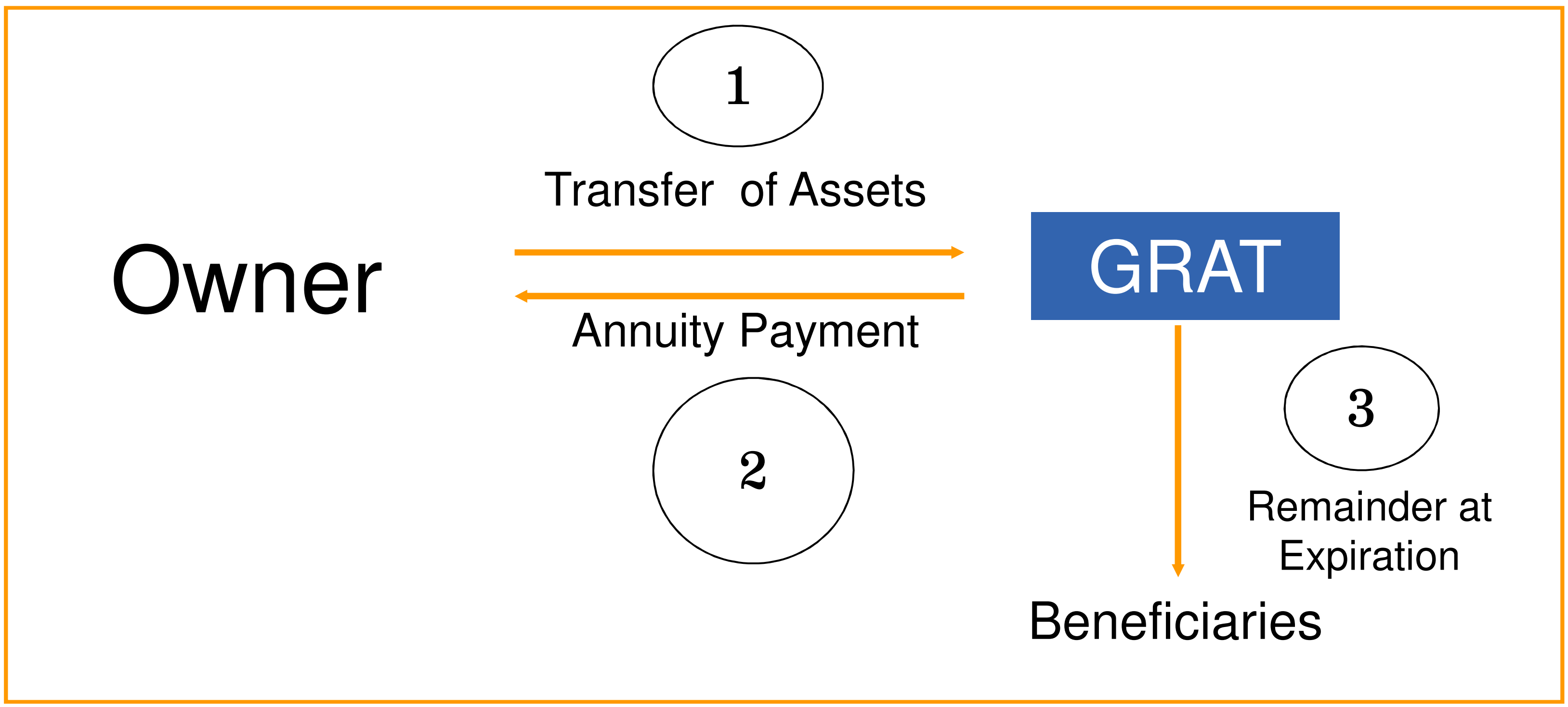
Tax Benefits

- The retention of an annuity stream by the grantor reduces the value of the gift; the GRAT can be structured to provide for zero gift at inception
- A GRAT is most beneficial when funded with an asset that is expected to appreciate significantly
- Transfer of the assets to the trust does not create an income tax event
- Freezes value of assets in owner's estate at time of transfer and gives beneficiaries almost all of the upside benefit of appreciation

Grantor Retained Annuity Trust (GRAT)

Mechanics

1) Assets are placed into an irrevocable trust for a fixed term
2) Fixed or variable annuity is paid to grantor during term of the trust
3) At the expiration of the trust term, the remaining assets are passed to beneficiaries or to a trust for the benefit of the beneficiaries



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Grantor Retained Annuity Trust (GRAT)

If **$1,000,000** is transferred to a GRAT . . .

	(1) Term	(2) Annual Payment	(3) § 7520 rate	Value of Retained Annuity	Taxable Gift
#1	*3 years*	*$100,000/year*	*2.0%*	*$288,390*	*$711,610*
#2	*10 years*	*$100,000/year*	*2.0%*	*$898,260*	*$101,740*
#3	*3 years*	*$346,753/year*	*2.0%*	*$1,000,000*	*$0*
#4	*10 years*	*$111,326/year*	*2.0%*	*$1,000,000*	*$0*
#5	*3 years*	*$374,111/year*	*6.0%*	*$1,000,000*	*$0*
#6	*10 years*	*$135,867/year*	*6.0%*	*$1,000,000*	*$0*

KEY OBSERVATIONS

- #1 & #2 - Notice how the amount of the taxable gift is smaller as the annuity term is extended.
- #3 & #4 – These are "zero-ed out" GRATs - the annuity payments are increased so the value of the retained annuity almost exactly matches the amount of the transfer to the trust.
- #5 & #6 – These are also "zero-ed out" GRATs – however, because the § 7520 rate increased, grantor will need to select a higher annual payment in order to "zero-out" the taxable gift. This results in less dollar value being left in the trust for the remainder beneficiaries after the expiration of the GRAT term.

Sale to a Grantor Trust for a Promissory Note

Overview

- Sale to an Intentionally Defective Grantor Trust (SIDGT) is a strategy that transfers future appreciation above an "inter-family loan rate" to family beneficiaries
- Assets are sold by the owner (not gifted) to the trust in exchange for an interest bearing promissory note

Tax Benefits

- Sale to trust of assets does not generate income tax: Trust is structured as an intentionally "defective" grantor trust so that owner continues to be responsible for income taxes but transfer is considered a completed gift for gift/estate tax purposes
- Grantor remains responsible for all income tax on income earned by trust and income tax paid by grantor does not constitute additional gift to beneficiaries
- Freezes value of assets in owner's estate at time of transfer and gives beneficiaries almost all of the upside benefit of appreciation

Sale to a Grantor Trust for a Promissory Note

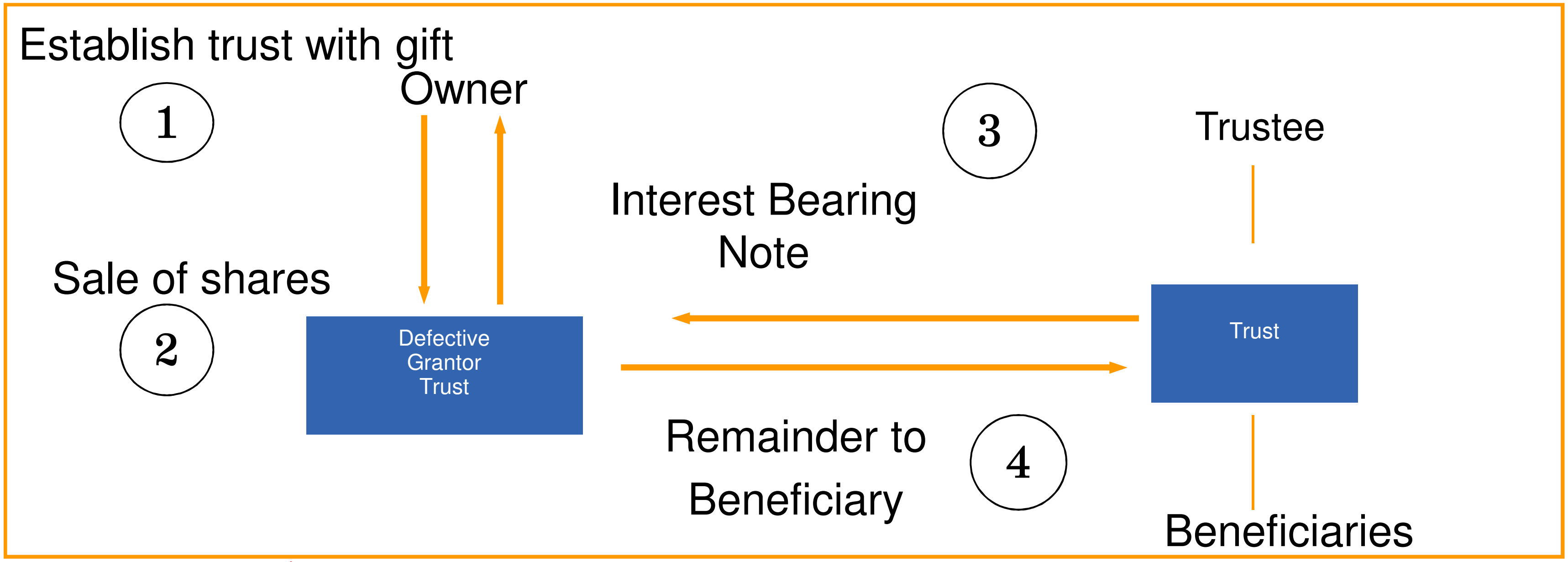
Mechanics

1) Grantor establishes trust; "seeds" trust with gift of cash or assets

2) Grantor sells assets to trust for a promissory note with "intra-family interest rate"

3) Interest on note is paid on current or accrued basis

4) Remainder passes to beneficiary at the end of the trust with no gift tax due; only value included in owner's estate is the value of the promissory note



Comparing a GRAT vs. SIDGT

	GRAT	**SIDGT**
Authority	Statutory	Though well established, tax statutes do not create SIDGTs. A combination and interpretation of statutes yields this strategy
Strategy's success requires assets to outperform IRS' hurdle rate	IRS hurdle rate is §7520 rate (i.e., 120% of mid-term AFR) in effect when GRAT created	IRS hurdle rate will always be lower than §7520 rate if SIDGT's term is 9 years or less
GST Planning	Grantor cannot allocate GST Tax Exemption to GRAT while Grantor is receiving annuity payments	Grantor can allocate GST Tax Exemption to "seed gift" to make SIDGT an exempt GST trust
Ability to stretch out payments	Payment must be made annually and can increase no more than 20% over the previous year's payment	Can "backload" by using a balloon note where the principal balance is paid during last year of the installment note
Ability to "Zero Out"	Can "zero out" by following the approach done in the Walton Tax Court case	Can "zero out" by not making a "seed gift," though it is considered more aggressive
Death during term: Estate tax result	Amount required to produce the annuity using the §7520 rate in effect and grantor's death	Grantor's Gross Estate will only include the unpaid principal balance and accrued interest on the note
Death during term: Income tax result	No income tax consequence	Some say gain on installment note is triggered as IRD; some say not

President’s Proposals – GRATs and SIDGTs

- GRATs must have a minimum term of 10 years and a maximum term of the grantor’s life expectancy plus 10 years
- GRAT remainder interests must have a minimum value equal to the greater of 25% of the value of the assets contributed to the GRAT or $500,000
- Prohibits the grantor from engaging in a tax-free exchange of any asset held in a GRAT
- After a transfer to a SIDGT, all future trust investment returns will either be included in the grantor’s estate or be a deemed gift from the grantor

Partnership Freeze - Overview

- Combines traditional trust and estate planning with better business transaction structures
- Provides an opportunity to complete a family's planning by addressing assets that have been reserved to support living expenses
- Provides cash flow to the primary contributor for life
- Provides primary contributor a method for more control of transferred wealth
- Provides primary contributor with potential access to transferred wealth

Partnership Freeze - Mechanics

- Client creates a new limited partnership or, more typically, a new limited liability company (collectively hereafter referred to as a "LLC") taxed as a partnership
- Client transfers assets into the LLC in exchange for a preferred interest
- These assets
  - may be other closely-held business interests, real estate, or other assets, and
  - should be expected to generate significant returns (income and/or appreciation)
- The preferred return is determined by a business appraisal (usually 6% to 8% of the asset value per year)

Partnership Freeze - Mechanics

Example:

- You create a new LLC and transfer commercial real estate business assets to the LLC, valued at $5 million, in an equal exchange for a preferred return.
- The preferred return is determined by appraisal to be 7.5% of your initial contribution or $375,000 annually.
- This preferred return is annually paid or accumulated for your benefit.

Partnership Freeze - Mechanics

- Client's children (or better, a trust for the benefit of client's descendants) transfer assets into the LLC in exchange for a common, or non-preferred, interest in the LLC equal to at least 10% of the value of the LLC assets
  - If a new dynasty trust is created, client can make a gift or loan to the dynasty trust, which can then use those funds to make its contribution to the LLC.
  - The gift might use some or all of the client's gift tax exemption amount
  - Alternatively, the dynasty trust might use a promissory note to fund some or all of the common owner contribution

Partnership Freeze - Mechanics

- The LLC may be structured so that the primary contributor of assets to the entity is named as LLC managing member
- Overly broad retained powers may be problematic
  - Section 2036 should not apply if the transfer is NOT for less than full or adequate consideration (if a transfer occurs, it should be a sale for full consideration)
  - Powers retained should respect the fiduciary obligation to other non-managing members of the LLC

Partnership Freeze - Operation

- Once all contributions are made, substantially all investment returns in excess of the preferred return will inure to the benefit of the common owner(s)
- This excess return will, therefore, not be included in the client's taxable estate
- The value of the preferred interest always should be approximately equal to its initial value
- In other words, the estate tax value of the preferred interest is essentially frozen at its initial contribution value

Partnership Freeze - Operation

Example expanded:

- The preferred return is determined by appraisal to be 7.5% of client's initial contribution or $375,000 annually.
- This preferred return is annually paid or accumulated for client's benefit and client uses this preferred return for living expenses, taxes, and/or other family or charitable gifts.
- Substantially all the return from the assets in excess of 7.5% annually will inure to the benefit of the dynasty trust for descendants.
- Years later at client's death, the preferred interest will be valued in the estate at approximately its initial contribution value of $5 million and the excess return will be owned by the next generations free of gift, estate, and generation skipping transfer taxes.

Partnership Freeze - Operation

- The preferred return must be paid by the LLC at least every eight years
  - Sec. 2701(d)(2)(C) technically permits a "qualified payment" to be delayed for four years from its due date
  - Regulations then permit the "qualified payment" to be paid with a promissory note payable after an additional four years (*See* Reg. Sec. 25.2701-4(c)(5))
- A cash distribution is not required, payment can be in-kind with various LLC assets

Partnership Freeze - Advantages

- **Control**
  - A primary consideration for a wealthy individual is the retention of control of business interests and other assets
  - Allows retention of control over assets for as long as desired while allowing the designation of a successor managing member
  - Both the GRAT and SIDGT require a third party trustee to control the assets

Partnership Freeze - Advantages

- **Access to Wealth**
  - Access to cash flow is of paramount importance for wealthy individuals who do not want to lose access to liquidity to facilitate estate planning
  - Permits the separation of ownership of the assets from their related cash flow
  - Can allow the managing member to lend LLC assets to any member including the managing member (provided acting as a fiduciary)

Partnership Freeze - Advantages

- **Flexibility/Governance**
  - LLCs allow changes to structure and, therefore, more future control over which members may ultimately benefit from its asset value
  - LLCs can incorporate a series of puts and calls which facilitate the orderly economic separation from the business for those family members who wish to cash out or who are disruptive, while preserving the economic integrity of the family business for decades

Partnership Freeze - Advantages

- **Asset Protection**
  - The LLC structure provides a strong level of creditor protection
  - The remedy of a creditor of any member is limited to a charging order against the member's interest, precluding the creditor's direct ownership of the assets within the LLC
  - Depending upon the irrevocable trust structure of the GRAT or SIDGT, this asset protection benefit may or may not be similar

Partnership Freeze - Advantages

- **Death**
  - The Freeze essentially establishes the constant value of the preferred interest from its inception until death
  - Death after the creation of the Freeze causes only the value of the preferred interest (plus any preferred return not consumed) to be included in the taxable estate
  - A GRAT may cause a greater value to be included in the taxable estate
  - For a SIDGT, only the note value should be included in the taxable estate

Partnership Freeze - Advantages

- **Statutory**
  - The Freeze obtains its structure from the Chapter 14 tax statutes (similar to a GRAT)
  - While estate planners have used the SIDGT technique for some time, it is not sanctioned by any particular tax statute

Partnership Freeze - Advantages

- **Planning for grandchildren**
  - The Freeze can benefit all future descendants (similar to a SIDGT)
  - Generally, the remainder beneficiaries of a GRAT would be only children, not grandchildren or further descendants (due to ETIP rules)

Partnership Freeze – Possible Disadvantage

- The premise for each of a GRAT, SIDGT, and Freeze is to transfer the future value above a set hurdle rate of return to the next generations
  - The GRAT hurdle rate is 120% of the mid term AFR, which is the IRS discount interest rate used to value the retained annuity
  - The SIDGT hurdle rate is the AFR charged on the note (either the short term, mid term, or long term AFR)
  - Generally, the hurdle rate for an SIDGT is lower than the hurdle rate for a GRAT
  - The hurdle rate is paid back to the grantor of the trust in addition to the frozen value of the assets
  - Some people refer to this excess as the "leak" in the frozen structure

Partnership Freeze – Possible Disadvantage

- The hurdle rate for the Freeze is generally higher than both a SIDGT and a GRAT
- Or, as some people might say, it has a greater leak
- This greater leak may cause a larger estate tax to be due after a Freeze than after using either trust technique
- From a pure estate tax point of view, the Freeze may be less beneficial than these other planning techniques
- **However, individuals concerned with both protecting their cash flow to maintain lifestyle and with minimizing estate tax may view receiving a greater specified return as a positive aspect of the Freeze technique**

Partnership Freeze – Other Issues

- The Freeze should only be used for assets that will likely produce a significant return over time
- Adding liquid assets like publicly-traded stocks and bonds to the LLC may add to the tax benefit of the Freeze by lowering the preferred return
- The Freeze should only be used by individuals who want or need to receive a significant return on contributed assets while transferring the future value, above the higher hurdle rate, to the next generations
- This greater cash flow can then be used to fund living expenses, tax liabilities, or to make additional family or charitable gifts