BLEAKLEY PLATT

Advanced Estate Planning Techniques

Introduction

Below we have described what we call advanced estate planning techniques that clients may wish to consider once they have basic estate planning documents in place. The descriptions below are not intended to be a discussion of all the technical requirements for each technique, but rather, a general description of the technique and how it works. If you would like to explore the use of any of the techniques described below, a member of the trusts and estates department would be happy to discuss the technique with you in detail and to prepare an analysis of how the particular technique would operate in your overall plan.

Qualified Personal Residence Trusts ("QPRT")

QPRTs are an estate planning technique specifically permitted under the Internal Revenue Code and Regulations. To use this technique, the grantor creates a trust to which he or she transfers a residence. Under the terms of the trust, the grantor may use the residence contributed to the trust for the trust term (the trust term chosen is designed to be shorter than the life expectancy of the grantor). The trust terminates at the end of the trust term and the residence passes either outright to the grantor's children or, as we generally suggest, in further trust. After the termination of the trust, the grantor may continue to have the use of the residence but he or she is required to pay fair market rent in order to do so.

Why QPRTs Work

QPRTs are effective because they allow the grantor to transfer a residence for less than its full value. This is possible because, for gift tax purposes, the value of the gift to the trust is equal to the full value of the residence less the value of the right, retained by the grantor, to use the residence during the trust term. In addition, the expectation is that the residence will appreciate faster than the interest rate prescribed by the Internal Revenue Service and the Regulations to determine the value of the interest retained by the grantor and the interest transferred. As long as the grantor survives the trust term, both the value of the residence and all future appreciation are removed from the grantor's estate.

Having the residence pass to a trust at the end of the QPRT presents an opportunity for additional estate planning benefits. If the continuing trust is structured as a grantor trust, under current law, the rent paid by the grantor is not treated as income to the trust. The end result is

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that the rental payments made by the grantor for the continued use of the residence pass to the lower generation free of tax. There has been some discussion recently in Congress of changing the grantor trust rules.

Caveats

If the Grantor does not survive the trust term, the value of the residence on the date of the grantor's death will be included as part of his or her estate for estate tax purposes. If the grantor paid gift taxes in connection with the transaction, the grantor's estate will receive a credit for gift taxes attributable to the transaction.

The grantor should be financially able to pay the rent for the residence, if the Grantor wishes to continue to occupy the residence after the initial trust term. If the rent is not paid, the benefits of the transaction may be lost or reduced.

The trust takes the owner's basis in the residence therefore, the capital gains taxes that will be paid on the sale of the residence after the grantor's death should be considered in determining the overall tax savings to be obtained by the transaction.

The Grantor will need to consider generation-skipping tax issues if the beneficiaries of the continuing trust may be grandchildren of the Grantor.

Grantor Retained Annuity Trusts ("GRAT")

Like the QPRT, GRATs are specifically permitted under the Internal Revenue Code and Regulations. To use this technique, the grantor creates a trust to which he or she transfers an asset or several assets, such as stock, partnership interests, interests in real estate, etc. Under the terms of the trust, the grantor retains the right to annuity payments (fixed payments determined based on the value of the assets transferred to the trust on the date of transfer) for the trust term. At the end of the trust term, the trust terminates and the trust assets are distributed either outright to the beneficiaries or to a continuing trust.

Why GRATs Work

As with the QPRT, GRATs are effective because they allow the grantor to transfer assets for less than the full value of the asset. This is possible because the value of the gift to the trust is equal to the full value of the asset transferred less the value of the annuity payments required to be paid to the grantor under the terms of the trust. In addition, the expectation is that the assets will appreciate faster than the interest rate prescribed by the Internal Revenue Code and Regulations to determine the annuity payments.

GRATs can be structured in such a way as to allow the initial gift to the GRAT to be valued at almost zero and, currently, can have very short terms. GRATs are particularly effective when the assets contributed appreciate in value rapidly.

Caveats

If the grantor does not survive the term of the GRAT, the value of the assets held in the GRAT will be included as part of the grantor's estate for estate tax purposes.

At the end of the GRAT term, the grantor will no longer have the benefit of the income from the assets transferred nor will he or she have the annuity income. The grantor must be comfortable with the level of his or her assets after the transfer.

Family Limited Partnership ("FLP") or Limited Liability Company ("LLC")

A FLP or LLC is not in and of itself an estate planning technique, but either may be used in estate planning under the right circumstances. Generally, the senior generation contributes assets to an FLP or LLC in return for limited partnership interests or limited liability company interests. The senior generation may then gift limited partnership interests or limited liability company interests, to the lower generation either outright or in trust.

Why FLPs or LLCs Work

FLPs or LLCs work if discounts are available when valuing the transferred interests. Two discounts are generally applied: (1) a lack of control discount and (2) lack of marketability discount. The concept of the discount for lack of control is that the owners of the interests do not have any control over the underlying assets of the partnership and so the value of the interest held by the partner or member is less than the value of the partner or member's share of the underlying assets, if the FLP or LLC were liquidated. The concept of the lack of marketability discount is that the limited interests are not readily marketable, as is a publically traded stock, so the true value of the limited interest is adjusted for lack of liquidity.

Caveats

FLPs and LLCs have come under intense scrutiny by the Internal Revenue Service in recent years. The Internal Revenue Service has taken the position that, in order for the various discounts to apply, the FLP or LLC must have been formed for a business reason. For this reason, a FLP formed solely to hold non-business property (e.g. marketable securities or cash) may very well be challenged by the IRS.

It is also problematic for the senior generation to retain control over the FLP and LLC. The Internal Revenue Service has aggressively argued that the control by the senior generation results in the transferred interest remaining subject to estate tax in the estate of the senior generation member.

Sales to Grantor Trusts

A sale to a grantor trust is, as its name suggests, a sale of assets to a trust. When using this technique, the grantor creates a trust to which he or she makes a gift. The terms of the trust are such that the grantor is treated as the owner of the trust for income tax purposes (the reason this is an advantage is explained below). The grantor then engages in a sale transaction with the trust. He or she sells assets to the grantor trust for fair market value as of the date of the sale in return for a note in the amount of the sale price. During the term of the note, the trust makes payments on the note and if the grantor dies during the term of the note, the outstanding balance on the note is included in the grantor's gross estate for estate tax purposes (variations of this technique include using notes which are cancelled upon he Grantor's death sometimes called SCINs).

Why Sales to Grantor Trusts Work

The interest rate charged on the note will be the minimum allowable Applicable Federal Rate. The expectation is that the assets sold to the trust will outperform the interest rate on the note; hence appreciation on the assets sold is removed from the grantor's estate. There are no income tax consequences to the grantor on the sale because the trust is a grantor trust and, as such, for income tax purposes, the grantor is treated as both the buyer and the seller.

Caveats

The assets do not receive a step up in basis on sale to the trust so the overall tax savings obtained from the transaction needs to be evaluated in light of the capital gains taxes that would be incurred on the sale of the asset by the trust.

Even though the transaction is a sale transaction, a gift tax return should be filed, so that the statute of limitations will begin to run with respect to the valuation of the assets sold remain a possibility.

It is important to make sure that the trust has sufficient assets and cash flow to make payments on the note. The valuation issues mentioned above will be exacerbated if the trust makes payments on the note by returning a portion of the assets sold.

Dynasty Trusts

Dynasty trusts are basically trusts designed to hold assets for multiple generations of a family. They make use of the exemption to the Generation Skipping Transfer Tax available under the Internal Revenue Code. To provide some background, Section 2601 of the Internal Revenue Code imposes a tax on Generation Skipping Transfers. While there is a complex set of rules for determining if a transfer is a Generation Skipping Transfer simply put, as the name implies, such transfers are basically transfers that bypass the generation immediately following the grantor's generation in favor of beneficiaries in a lower generation. The Generation Skipping

Transfer Tax is designed to capture the transfer tax that would have been paid by the "skipped" generation.

Under the Internal Revenue Code an exemption to the Generation Skipping Transfer Tax is allowed, in other words, you may pass a certain amount of wealth to a lower generation without incurring a Generation Skipping Transfer Tax. The current exemption matches the Federal Estate and Gift Tax Exemption, $5,240,000.

Dynasty Trusts are generally established in a jurisdiction that does not have a rule against perpetuities. The rule against perpetuities is an ancient doctrine that requires all interests in property to vest within a certain period (often a life in being plus twenty-one (21) years). In other words, the trusts must terminate within the defined period. Some jurisdictions, such as Delaware, do not have a rule against perpetuities and so trusts can extend over multiple generations. Therefore, Delaware has become a favored jurisdiction for the creation of these trusts.

A Dynasty Trust can have many different purposes and the provisions will vary but in general, the grantor creates a trust and transfers assets to the trust. The grantor then allocates all or a portion of his or her Generation Skipping Transfer Tax Exemption to the trust. The assets held in the trust remain in trust to benefit multiple generations.

It is important to understand that the Generation Skipping Transfer Tax Exemption is not in addition to the Estate and Gift Tax Exemption. In order for a transfer to be free of estate, gift and Generation Skipping Transfer Tax the grantor will need to allocate both Generation Skipping Transfer Tax Exemption and Estate and Gift Tax Exemption.

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