



USE OF A RETAINED INTEREST TRUST IN COMBINATION WITH A FAMILY PARTNERSHIP

By: Alexander A. Bove, Jr., Esq. and Melissa Langa, Esq.

[Originally published in Massachusetts Lawyers Weekly December 13, 1999]

With a nod to Benjamin Disraeli, it might be said of late that the Internal Revenue Service believes in three kinds of lies: lies, damn lies, and discounts.

This is not to say that discounts, for estate planning purposes, are in the category of “lies.” Perhaps a better way to put it is that valuation discounts are a legal way to reduce the truth. This advantage particularly comes to bear in one of the latest, if not one of the most common ways of saving estate and gift taxes. Clients transfer assets into a family limited partnership (FLP) in return for general and limited partnership shares. Then they make a gift of non-marketable nonvoting limited partnership shares to (typically) children. As explained later, these shares should reflect a discount from their proportionate value of the partnership assets because of the restricted rights attached to them. Now, estate planners can take the discount allowance even further by combining the partnership discount with a future interest discount.

Consider the following: Leona, a healthy 70 year old widow, owns and operates a hotel with a fair market value of \$800,000 and a low tax basis. The business produces \$70,000 of net income (before taxes) a year and there is no mortgage on the property. Leona has three adult daughters, and three minor grandchildren. Two daughters have become interested in the family business, while the remaining daughter is disabled and receiving governmental assistance (SSI). Leona is weary of business responsibilities (although she would hate to lose all that income), and has considered selling the hotel, but because her two able daughters are now interested in the business, and because she has heard that casino gambling may come to town (making her property considerably more valuable), she has decided to hold on to the hotel for now “for the family”. Leona’s total estate is valued at \$2.5 million.

Family Limited Partnerships

A goal of Leona's estate planning lawyer should be to reduce the size of Leona's estate, while retaining Leona's right to receive at least a portion of the hotel income. In 2000, Leona will have an "applicable exclusion amount" (AEA) for gift and estate tax purposes of \$675,000: that is, she can gratuitously transfer property valued at \$675,000 without incurring an estate or gift tax. IRC Section 2010. Even if Leona lives to the year 2006 when the AEA increases to \$1 million, it is evident that she must "leverage" the use of her AEA if she is to achieve significant estate reduction without the payment of gift tax. One way to leverage the AEA is through the use of discounts. A companion article in this issue of MLW contains a thorough analysis of the operation of discounts within a FLP which will not be reiterated in depth here. Briefly, property is transferred into a FLP in exchange for a limited partnership (LP) interest. The LP interest does not have the same value as the underlying partnership property because the holder of the LP interest is unable to control the disposition of the property. Thus, when valued, the LP interest is traditionally discounted for the limited partner's lack of control, the lack of marketability of the LP interest itself, as well as other discount factors. The IRS has long accepted the theory behind reasonable discounts in such cases, although in extreme cases it continues to litigate their application in a family limited partnership setting. Manigault and Hodges II, *Valuation Discounts – An Analysis of the Service's Position Compared With Litigated Cases*: 91 Journal of Taxation 26 (July 1999).

Here, the hotel is an ideal asset for a FLP, especially in Massachusetts, which requires a "for profit" business purpose for a partnership's formation. G.L.c. 109, section 6 and G.L.c. 108A, section 6. If a client is not carrying on a business for profit, the FLP may be established in Delaware, for example, or any jurisdiction where a partnership may be established for any lawful purpose. See, for example, 6 Delaware Code Section 17-106(a). For the purposes of this article, Leona will form her FLP in Massachusetts, although she gives up the opportunity for larger discounts that can be justified in a jurisdiction where a limited partner does not have the right to withdraw from the partnership. See, for example, 6 Delaware Code Section 17-603.

As the first step in forming the FLP, Leona should be advised to obtain a complete qualified appraisal of the hotel business in order to establish its fair market value going into the FLP. Note that *no* discount attaches upon the transfer of the asset *into* the FLP; rather, the property's full fair market value is used to value the contributions of the partners, and a taxable gift does not result upon the transfer into the FLP. Once the partnership is formed, a second qualified appraisal is usually undertaken to establish the fair market value of Leona's LP interest. It is here that the discounts discussed above come into play, although they will not be important until Leona begins to gift her interest, as discussed below.

In addition to providing the initial dip into the discount pool, the FLP enables Leona to involve her two interested daughters in the operation of the hotel. For example, Leona can transfer the \$800,000 hotel into the FLP in exchange for a 98% LP interest, while her entrepreneurial daughters can each contribute \$8,163 cash in return for a 1% general partnership

interest. As general partners, the daughters will control the day-to-day operation of the hotel. If the general partners are cash poor, Leona can gift the cash to each daughter utilizing her Section 2503 annual exclusion from gift tax for present interest gifts of \$10,000 or less. Additionally, if Leona is not yet ready to yield full control to her daughters, she could instead be a 95% limited partner and a 3% general partner.

Leona is now primed to gift her LP interests to her children, utilizing the discounted value of her LP interest discussed above. Assuming a 40% discount is applied, her LP interest will be valued at \$480,000 (60% x \$800,000) --- but this takes a healthy bite out of her available AEA, and Leona is not sure that she is ready to part with all the income so fast. Further, if Leona desired to use the present interest annual exclusion to gradually gift the LP interest to her three children, it would take about 16 years to do so, two years longer than her present life expectancy of 14 years. Finally, the yearly gifts would entail concurrent annual qualified appraisals to value the LP interests transferred.

What can Leona do? A knee-jerk reaction to this dilemma might be to increase the discount and hope for the best. However, a more creative, and conservative approach would be to advise Leona to transfer her LP interest into a retained interest trust for the benefit of her daughters.

Retained Interest Trusts

The 1990's introduced the "Special Valuation Rules" into the tax code, affecting the valuation of gifts where the donor retained an interest (e.g. the right to receive income) in the gifted property. Chapter 14 of the Code, IRC Section 2701 – 2704. Effectively, whenever a transferor (grantor) transfers property and retains a "nonqualified" income interest, the amount of the gift of the remainder interest in the trust (if held by certain family members) is, generally speaking, the full value of the transferred property, because the nonqualified income interest retained by the transferor is valued at zero. IRC Section 2702(a)(2) and Reg. 25.2702-2(a)(5). For our purposes, what is important is that IRC Section 2702 exempts certain retained interest trusts from these harsh valuation rules as long as the retained interest is "qualified". IRC Sections 2702(a)(2)(B) and 2702(b).

One type of qualified interest can be achieved through an irrevocable grantor retained annuity trust (GRAT) as long as the grantor retains an irrevocable right to receive at least annually for a term of years a fixed amount as stated either by a sum, or by a percentage of the fair market value of the property as valued at the time of the transfer. Reg. 25.2702-3(b)(1)(i). Additional requirements include the prohibition of additional contributions in the trust

instrument, as well as a requirement that the grantor's interest shall not be subject to commutation (where the trustee could "buy out" the remainder of the grantor's payments prior to the end of the term). If those and all other IRC requirements are met, the gift of the remainder interest will be valued under traditional rules allowing for present valuation of the remainder and term interest. IRC Section 7520 and the Regulations thereunder.

Even though the applicable rate is currently rising (this December's Section 7520 rate is 7.49%), Leona can reap dramatic benefit from a transfer of her LP interest into a GRAT even though, as a general rule, the higher the IRC Section 7520 rate, the greater the value of the remainder interest, and thus the greater the value of the gift.

To illustrate, Leona transfers her discounted \$480,000 LP interest into a properly structured GRAT in which she retains the right to receive annual payments of income equal to 12% of the assets in the GRAT (fixed at \$480,000), or \$57,600 a year. Under Section 7520, the value of the taxable gift of the remainder interest (a future interest not eligible for the present interest annual exclusion) is approximately \$138,000. The GRAT and FLP "double dip" produces a combined discount of almost 83%! Note that the gift of the remainder interest is a future interest not eligible for the present interest annual exclusion under IRC Section 2503.

The transfer of Leona's LP interest into the GRAT will necessitate the filing of a Form 709 federal gift tax return, including the allocation of \$138,000 of Leona's AEA to the gift. Both the Taxpayer Relief Act of 1997 and the IRS Restructuring and Reform Act of 1998 require that Leona provide "adequate disclosure" on the Form 709 in order to trigger the running of the statute of limitations period regarding re-determination of fair market value. On December 3, 1999, the IRS issued final regulations outlining its position on adequate disclosure. T.D. 8845. As was anticipated, fair market value determinations including discounts come under particular scrutiny. This fact, however, is not a reason to avoid gifts with discounts as they are quite commonly and successfully used.

The beauty of the FLP-GRAT is that each discount is in of itself is modest and, if fairly calculated, justifiable to the IRS upon audit. But in addition to this virtue, the use of the GRAT has other important advantages. Because the GRAT is typically a "grantor trust" under IRC Section 677, Leona will pay the income tax on the entire \$70,000 of net income each year, even though she only receives the annuity amount of \$57,600. The \$12,400 non-distributed excess income (\$70,000 less \$57,600) may be accumulated within the trust (as principal) gift tax free for the ultimate benefit of the remaindermen at the end of the ten year trust term. Alternatively, the GRAT may provide that in addition to the annuity payment, Leona will receive an amount equal to the income tax she must pay on the excess income. It is presently an open question as to whether the payment of the income tax without GRAT reimbursement is considered an

additional gift to the remaindermen. The more conservative approach is to include the extra payment provision.

A further advantage of the GRAT is that Leona has removed not only \$800,000 from her estate (assuming she outlives the term as discussed below), but also of all the appreciation of the GRAT property over the ten year term. For example, assuming a modest 5% growth in the fair market value of the hotel, its value to the remaindermen at the end of the trust term will be close to \$1.3 million --- all for a gift tax value of only \$138,000.

Finally, Leona continues to benefit if, in fact, the hotel is sold within the trust term. She would continue to receive the 12% annuity based upon the \$480,000 date-of-transfer benchmark, and would pay the capital gains tax due upon the sale, preferably out of non-GRAT assets, thus further reducing her estate.

Practical Considerations

A number of practical considerations attend the use of the FLP-GRAT double dip. The first is the selection of the appropriate term for the retained income interest. This is important because the IRS position is that death of the grantor within the term brings the entire property back into the estate under IRC Section 2039. PLR 9451056 (September 26, 1994). Therefore, the practitioner will want to determine a healthy Leona's life expectancy, and work backwards from that number, remembering that the shorter the term, the larger the gift, and the less leverage achieved. In the example above, if Leona retained a six year qualified interest (rather than ten), the amount of the gift increases to \$231,000. The selection of the appropriate term depends in part in the level of risk Leona is willing to assume. As an aside, it is important to inform Leona that the annuity payments may not be accelerated if she becomes critically ill or financially needed during the term because, as stated above, commutation of the qualified interest is not permitted. Reg. 25.2702-3(d)(4).

Regarding the amount includable in Leona's estate should she die within even the most carefully, conservatively selected term, some commentators believe that the amount includable in Leona's estate is *not* the entire value of the GRAT property, but rather the amount of trust property which would generate the income necessary to produce the annuity amount for the lifetime of a person of Leona's age at her death. See Rev. Rul. 82-105, 1982-1 CB 133 (charitable remainder annuity trust).

Once the term is set, selection of remainder beneficiaries needs thoughtful consideration. If the entrepreneurial children are earning income through management fees, it might be that Leona wants her disabled child to receive a greater percentage of the GRAT property in order to equalize her treatment of the three children. In order to preserve that disabled daughter's entitlement to governmental benefits, the GRAT beneficiary should not be the individual child, but rather a supplemental needs trust or fully discretionary trust for the benefit of that child. See, generally, Bove & Suisman, *Use of Trusts in Personal Injury Settlements*, M.L.W. June 1994.

The practitioner must also be aware that the IRC generation-skipping transfer tax rules, IRC Sections 2601-2662, provide serious traps for the unwary when choosing a beneficiary, and structuring a beneficial interest. First, it would be a mistake to include Leona's grandchildren as GRAT beneficiaries. Gifts to her grandchildren are subject to a flat 55% generation-skipping transfer tax (in addition to whatever gift tax may be due) unless Leona allocates to the gift a portion of her generation-skipping transfer tax (GSTT) exemption (presently \$1,010,000). However, because the trust property may be included in Leona's estate during the ten year trust term (in the event of her death), this "estate tax inclusion period" (ETIP) precludes the effective allocation of GSTT exemption until the termination of the GRAT, when the value of the property could exceed her allowable GSTT exemption. IRC Section 2642(f)(3) and Reg. §26.2632-1(c)(2). And see *Simches v. Simches*, 423 Mass 683, 671 N.E.2d 1226 (1996). Leona is better off omitting her grandchildren from the GRAT and looking for more productive uses for her GSTT exemption. Second, if a daughter dies during the trust term without inclusion of the GRAT trust interest in her estate and the interest thereafter passes to a skip person, GSTT problems arise. Therefore, the accepted approach is to give the child a testamentary general power of appointment within the GRAT to insure estate inclusion in the child's estate and avoiding a generation skip by the grantor.

Drawbacks

As with any estate planning technique, there are potential drawbacks Leona must be aware of when considering whether to implement the FLP-GRAT plan. First, the hotel may decline in value. Consider that instead of a casino, a chicken processing plant is built nearby. In that event, Leona may have wasted her AEA in that the value which passes to the remaindermen at the end of the GRAT may be less than the value assigned to it on the date of the initial transfer into the GRAT.

Another risk is that the fair market value of Leona's LP interest as finally determined for gift tax purposes may be greater or less than the value assigned by the qualified appraiser (the second appraisal). To preserve the annuity as a "qualified interest", the GRAT should provide that the trustee will pay the grantor (an initial overvaluation) or the grantor will pay the trustee (an initial undervaluation) an amount equal to the difference between the properly payable annuity and the actual annuity amount paid.

And then there is the possibility that the hotel fails to produce sufficient income to make the annual payment of \$57,600. This problem is not solved by the trustee simply making a promissory note payable to the grantor because the IRS' position is that a note is merely a promise to pay in the future which renders the retained interest unqualified: the annuity is no longer a fixed right to receive a payment at least annually. Proposed Regulation 20.2702-3 (REG-108287-98, 64 Fed.Reg. 333235 (June 22, 1998); TAM 9604005 (October 17, 1995); TAM 9717008 (April 25, 1997). Additionally, the proposed Regulations require the trust instrument to expressly prohibit the use of a note to pay the annuity. Proposed Reg. 25.2702-3(d)(5).

If the income falls short of the annuity obligation, the trustee will most likely have to make in-kind distributions to Leona of LP interests sufficient to meet the intractable \$57,600 obligation. This distribution would not be considered a "sale" of the trust property to satisfy the annuity obligation because (remember) the GRAT is a grantor trust as to Leona during the trust term. Rev. Rul. 85-13, 1985-1 CB 184. This re-distribution of LP interests back to Leona partially defeats the original intent of the GRAT but all may not be lost if the hotel has actually increased in value even though its production of income had dropped. For example, the underlying real estate may increase in value while the business's income production as a hotel declines. In that event, the GRAT's LP interest would have also increased in value, and Leona would be distributed a lesser LP interest to satisfy the annuity than she originally transferred to the GRAT.

Conclusion

As most estate planners recognize, the challenge of our specialty is in developing and implementing an arrangement or a combination of arrangements that legally accomplish the client's dispositive and tax objectives. In our illustration above, by utilizing the double dip FLP-GRAT, the client's income-producing business is transferred to her daughters with a minimum of gift and estate tax exposure, while providing an income to the client and while also keeping within the conservative parameters established by the tax code and by and the IRS.

Copyright 1999 by Alexander A. Bove, Jr. and Melissa Langa. All rights reserved.