# FAMILY WEALTH AND BUSINESS SUCCESSION PLANNING

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**June 14, 2007**

**The Oregon Society of Certified Public Accountants**
**OSCPA Estate & Trust Conference**
**Double Tree Hotel**
**Lloyd Center**
**Portland, Oregon**

**June 14, 2007**

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SCHEDULES 1-4 ATTACHED

# FAMILY WEALTH TRANSFER AND
# BUSINESS SUCCESSION PLANNING

## I. INTRODUCTION

### A. Background.

**1. Lifetime focus.** The old adage, “Most people don’t plan to fail, they just fail to plan” is a central component of successful wealth transfer and business succession planning. Effective wealth transfer focuses more on lifetime planning opportunities and objectives rather than defaulting to the inevitable transfer of wealth at death. Your client will appreciate advice that provides opportunities for family members during your client’s lifetime, effectively reduces exposure to transfer taxes and enhances your client’s quality of life. Impacting the process effectively during lifetime rather than letting the chips fall where they may at death generally results in better outcomes for the family.

**2. The wealthy are different.** As observed by F. Scott Fitzgerald, “The rich are different than us”. Of course, the novelist Ernest Hemingway correctly noted, “Yes, they have more money”. However, we also need to recognize the many psychological issues that affect family wealth transfer and business succession. Families with significant wealth face many complexities which can cause them great anxiety. They are not worried that their children will miss meals, just the opposite - they often fear that giving their children too much will demotivate their children and turn them into wastrels. Many resources refer to these concerns and they are real.[1] Warren Buffett expressed his concern that “I still believe in the philosophy - FORTUNE quoted me saying this 20 years ago - that a very rich person should leave his kids enough to do anything but not enough to do nothing”.[2] As we know, Mr. Buffett put his money where his mouth was by donating the majority of his wealth to charity. Mr. Buffet’s friend Bill Gates is reportedly limiting distribution to his children to $10MM each. While a substantial sum to many of us, the amount of income derived from this principal sum on an endowed basis provides a nice living equivalent to $500K per year pre-tax but does not allow for consumption of principal without a corresponding reduction in income.

**3. This outline addresses planning for family wealth in two categories:**

a. Transfers of family wealth (nonbusiness assets such as publicly traded stocks, bonds, cash and real estate).

b. Planning for family business succession (operating assets, real estate used in the operation, etc.).

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[1] For example, Willis, Thayer Cheatham, *Navigating the Dark Side of Wealth, A Life Guide for Inheritors.* Portland, Oregon, New Concord Press, 2003, to cite a local author.
[2] Loomis, Carol J., Fortune Magazine, June 25, 2006, in an interview with Warren Buffett quoting The Fortune article, "Should You Leave It All to the Children?" Sept. 29, 1986.

## II. LIFETIME TRANSFERS OF FAMILY WEALTH – EFFECTIVE TOOLS AND TECHNIQUES

### A. Sale.

1. Historically low income tax rates on capital gain. Do not overlook the obvious, simple, tried and true. A cash, installment, bargain sale or private annuity to family members all offer a means to transfer property at relatively low capital gain rates during lifetime. Long term capital gains on a sale of qualifying property by Oregonians would generally be taxed at a combined federal and state effective tax rate of 22.65% (15% federal plus 9% state with the state rate reduced by 15% due to the deduction of state income taxes on the federal return).[3] Of course, purchasing family members may need to pay income tax on funds earned to pay the obligation. Gifts of funds, independent of any "understanding" or the use of other capital may reduce overall taxes.

2. As an estate "freeze". While not often utilized as a wealth transfer technique, a sale of rapidly appreciating property at low capital gain rates and low interest rates does freeze the value of the asset in the estate. The value of the note in the decedent's estate may also be discounted based upon the term of the note, the interest rate, lack or adequacy of security and other factors. Although the transfer at death of an installment obligation does not accelerate the reporting of gain by the decedent's estate generally[4], the disposition of an installment obligation to the obligor by specific bequest or by cancellation of the debt at death requires recognition of income in the respect of a decedent upon the transfer to the decedent's estate.[5] Note, however, that the obligor does not have to recognize income on the cancellation of the debt upon receipt of their obligation nor does the specific bequest carry out DNI (distributable net income) to the obligor.[6] Techniques such as leaving the obligation to a trust for the benefit of the obligor for the term of the obligation or by using SCINs (self-cancelling installment notes) can avoid the acceleration of gain or even the recognition altogether.

### B. Annual Exclusion Gifts

#### 1. How much can I give my children/grandchildren each year without paying gift tax?

a. A transfer of $12,000 per year of personal or real property can be transferred gift tax free to any person each year.[7]

b. The transfer must be of a *present interest* in property, not of a future interest.[8] GP's gift of stock to C or GC outright or in a UTMA transfer qualifies; a gift in trust which distributes at age 30 does not.

c. A gift tax return is required if the cumulative value of all gifts to

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[3] I.R.C. Sec. 1(h)(1)(C) and ORS 316.037
[4] I.R.C. Secs. 453B(c) and 691(a)(4).
[5] I.R.C. Sec. 691(a)(5).
[6] I.R.C. Sec. 663(a).
[7] I.R.C.Sec. 2503(b).
[8] I.R.C. Sec. 2503(b).

any one donee exceeds the annual exclusion.[9] GP provides GC with a birthday gift of $10,000 in January and a graduation gift of $3,000 in June—a return is required.

d. What if my spouse owns cash or property to give but I don't? How can we use each of our annual exclusions?

1) If both spouses are citizens or residents of the United States, a gift by one spouse to a third party can be treated as made one-half by each.[10]

2) This treatment is available only upon the consent of each spouse by signing gift tax returns for each spouse for the year of the gift while they were married.[11]

3) A gift tax return need not be filed by the consenting spouse if the amount given to any donee is a present interest gift which does not exceed twice the value of the annual exclusion (i.e., $24,000) while the donor's are married.[12]

**2. How do I make a gift to my child/grandchild if they are a minor?**

a. UTMA Gifts to Minors under ORS 126.805 to 126.886

A transfer of property to or for the benefit of a person who has not attained the age of 21 years (a "Minor"), may be made to a custodian for the benefit of a minor. While gifts to minors using Oregon's Uniform Transfer to Minor's Act (the "Act") permits placement of the title in a custodian until the minor is age 25, the Internal Revenue Code limits the maximum age for present interest treatment for purposes of the annual exclusion to age 21.[13] Therefore, it would be necessary to limit the age in the transfer document under the Act to age 21 to avoid the loss of the annual exclusion if qualification for that exclusion is intended. Gifts to custodians for the benefit of minors should use language provided by the statute as follows:

1) "As custodian for _____ (name of beneficiary) under the Oregon Uniform Transfers to Minors Act", or

2) If the transfer will be delayed until a time after the beneficiary turns 21 but before age 25, "As custodian for _____ (name of beneficiary) under the Oregon Uniform Transfers to Minors Act until the beneficiary attains the age of ____ years."[14]

3) A custodian must transfer the property to the beneficiary upon the earlier of the beneficiary's:

a) 21st birthday if the gift was irrevocable and not

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[9] I.R.C. Sec. 6019.
[10] I.R.C. Sec. 2513(a)(1).
[11] I.R.C. Sec. 2513(a)(2).
[12] Regs. Sec. 25.2513-1(c). *See* Form 709, Specific Instructions. Although not specifically mentioned in Regs. §25.2513-1(c) or in the instructions to Form 709 describing the §2513 election, the §2503(e) exclusion may also eliminate the need for the non-donor spouse to file a gift tax return if he or she is not otherwise required to file one. *See* Regs. Secs. 25.6019-1, -2.
[13] I.R.C. Sec. 2503(c)
[14] ORS 126.832(3)(a) and (b)

delayed until age 25,[15]

b) 18th birthday if the transfer was in the absence of a will or under a will or trust that did not contain an authorization to transfer to a custodian, or[16]

c) The beneficiary's death.[17]

**3. Example.** The amount of wealth that can be transferred over time to children and grandchildren using annual exclusion gifts can be significant as illustrated by the following example:

The Smiths wish to transfer substantial portions of their property (cash, stocks, real estate, etc.) annually using annual gift tax exclusions. Mr. and Mrs. Smith have two children and four grandchildren. The Smiths can each give $12,000 per year to each of their children and grandchildren for a total to each donee of $24,000. With six donees, they transfer $144,000 annually free of gift tax ($24,000 X 6).

If only one of the Smiths owned the property, the couple can elect to split the gifts taking advantage of the annual exclusion for the non-owner spouse as well.[18]

Over the ten year span of expected ownership and use, the Smiths could transfer $1,444,000 ($144,000 X 10), assuming no change in the amount of the annual exclusion. By removing $1,444,000 from the Smith's estate with lifetime transfers the asset escapes estate tax saving up to $649,800 ($1,444,000 x 45%) and perhaps more by removing appreciation in the asset value until the donor's date of death.[19]

Nevertheless, this technique however effective at saving transfer taxes for the family often is insufficient alone to solve the senior generation's transfer tax problem. An asset worth $2,000,000 that appreciates at 8% per year will appreciate at a rate in excess of the amount that could be given away annually in this example. If appreciation amounts to $160,000 ($2,000,000 X 8%), gifts of $144,000 will not remove sufficient value from the estate to completely cap estate value increases.

Combining annual exclusion gifts with valuation discounts, however, can increase the effectiveness of gifts and reduce transfer taxes significantly through greater leverage. Taxpayers have successfully justified valuation discounts for gifts of portions of interests in property, notably tenancy in common interests in real estate[20], gifts of stock in closely held companies, membership interests in limited liability companies or partnership interests in partnerships and the like. Assuming a discount, for example, of 20% for a tenancy in common interest in real estate, the annual gifting technique accelerates the transfer process. Using the same facts of this example and applying the 20% discount, the Smiths can give $15,000 per year to each of their

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[15] ORS 126.869(1)
[16] ORS 126.869(2)
[17] ORS 126.869(3)
[18] I.R.C. Sec. 2513
[19] I.R.C. Sec. 2001(c)(2).
[20] In *LeFrak v. Com'r*. T.C. Memo 1993-526 (20% minority interest in commercial real estate and 10% lack of marketability discounts); *Shephard v. Com'r*., 115 T.C. 376 (2000) (15% discount for undivided one-half interest in timberland); *Estate of Stevens*, T.C. Memo 2000-53 (25% discount for undivided one-half interest in commercial real estate); TAM 9336002 (discount limited to costs of partitioning property) but see *Estate of Cervin v. Comm'r*, 68 T.C.M. (CCH) 115(1994) where the court permitted a 20% discount (5% plus half of the cost to partition the property where one-half interest valued)

children and grandchildren for a total to each donee of $30,000 ($15,000 X 2 X 80% = $24,000). With six donees, the annual gift tax free transfer can total $180,000 ($30,000 X 6 X 80%). Over the ten year span of expected ownership and use, the Smiths could transfer $1,800,000 ($180,000 X 10), assuming no appreciation in the asset or change in the amount of the annual exclusion. Additional savings in transfer taxes through this leveraging technique amounts to $160,200 (1,800,000 – 1,444,000 = 356,000 x 45%) and perhaps more by removing appreciation in the asset value until the donor's date of death.

a. Can I use a trust to manage the gift until the children/grandchildren are mature enough to receive the gift outright?

1) A gift into a 2503(c) trust can defer distribution until the beneficiary reaches age 21 as long as the property and income from the gift in trust may be spent for the beneficiary before age 21 or, if not spent by age 21, will be distributed to the beneficiary at age 21. If the beneficiary dies before attaining age 21, the trust must distribute to the estate of the beneficiary or as the beneficiary appoints under a general power of appointment.[21]

2) The trust term may be extended beyond age 21; however, that right must be given only to the donee/beneficiary.[22]

3) A gift into trust that lasts beyond age 21 can also provide a vehicle for managing the property; however, qualification of annual exclusion gifts requires that the trustee grant access to the gift for a short period of time following the transfer into trust. Trusts providing such access are often referred to as "Crummey Trusts" after the 9th Circuit case of *Crummey v. Com'r*[23]. Providing the beneficiary with a mandatory power to withdraw the contribution for a short period of time (30-40 days) categorizes the gift as a *present interest gift* qualifying it for the annual exclusion under I.R.C. 2503(b). Care must be taken in designing trusts where the donor expects to transfer amounts in excess of the "5 & 5" amounts. Gifts that exceed the greater of 5% of the value of the trust property over which the power could be exercised or the value of $5,000 into Crummey trusts can affect the *beneficiary/donee* power holder of the Crummey power. The *lapse* of a power, that is the nonexercise of that power, can be treated as a gift by the power holder to third parties if the value of the property exceeds the 5&5 amounts exempt from the gift.[24] Because the amount treated as a gift by the power holder generally does not qualify as a gift of a present interest as it usually continues in trust, the power holder would need to file a gift tax return and use part of the lifetime gift tax exemption rather than the annual exclusion. Trusts can be designed to avoid this result with some tradeoffs in attractiveness to the donor.

b. Separate shares with general power of appointment. The trust may divide deposits into designated shares for each beneficiary who is granted a general power of appointment exercisable at death over their share. This technique prevents the lapsed gift from becoming a completed gift to another beneficiary.

c. Hanging Power. The lapsed amounts may continue to be subject to withdrawal rights in subsequent gifts, a "carryover" power granted to the power holder. If, for

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[21] I.R.C. Sec. 2503(c).
[22] Regs. Sec. 25.2503-4(b)(2)
[23] 397 F.2d 82 (9th Cir. 1968).
[24] I.R.C. 2514(e).

example, a power holder passes on withdrawing the donor's gift of $12,000 and the deposit becomes a part of the general assets of the trust, the amount in excess of the protected lapse amount is $7,000 ($12,000 - $5,000). If the trust grants the power holder a withdrawal right in subsequent years over this excess $7,000, the excess is not a "gift" as the power continues over the lapsed amount.[25]

d. Cascading Crummey Powers. The power to withdraw amounts in excess of the amounts qualifying for the annual exclusion under the lapse rule "cascade" or pass on to another set of beneficiaries, such as to children of the child/beneficiary, who may then withdraw a proportionate amount of the excess.[26]

**4. How can I help my children/grandchildren with their education without paying gift tax?**

a. Payments for tuition for the education or training of the individual are excluded from gift tax if paid to an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the pace where its educational activities are regularly carried on. I.R.C. §§2503(e)(1)(A) and 170(b)(1)(A)(ii). GP sends a check to the university for GC's tuition.

b. Note that payments to the *individual student* so that they can pay their own tuition do <u>not</u> qualify for this exclusion. GP's reimbursement of GC's payment of tuition falls outside the exclusion and is subject to gift tax reporting as an annual exclusion gift if the amount exceeds the annual exclusion.

c. A contribution to a qualified tuition program (a "529 Plan") on behalf of a designated beneficiary is treated as a completed, present gift (not a future interest) but is not treated as an excluded educational gift under I.R.C. §2503(e)[27]. Such contributions are treated as qualifying for the annual exclusions and are subject to generation skipping rules; however, amounts in excess of the annual exclusions (currently $12,000) can be taken into account by the donor ratably over a five-year period beginning with the contribution year by an election taken on the gift tax return.[28] A donor and spouse could each deposit $60,000 for a total deposit of $120,000 into the plan in one year and each treat the deposit as an annual exclusion gift ratably over the next five years.

d. If the donor dies before the five year period in which an election is in place, the donations prorated after the donor's date of death will be included in the donor's gross estate.[29]

e. Distributions from a 529 Plan are not considered taxable gifts[30] unless a new beneficiary is designated who is not of the same or higher generation than the old beneficiary or is not a member of the same family of the old beneficiary. Permissible

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[25] *See* PLRs 9030005, 8701007.
[26] "Cascading Crummey Power" is a service mark of Jonathan G. Blattmachr. *See* Slade & Blattmachr, "Skipping Generations With Irrevocable Life Insurance Trusts," 132 *Tr. & Est.* 10 (Apr. 1993).
[27] I.R.C. Sec. 529(c)(2).
[28] I.R.C. Sec. 529(c)(2)(B).
[29] I.R.C. Sec. 529(c)(4).
[30] I.R.C. Sec. 529(c) (5)

replacement beneficiaries include the following persons who hold these designated relationships to the old beneficiary: spouse, child, sibling or step sibling, ancestor, niece or nephew or aunt or uncle or certain in-laws or individuals who are step related or their spouses or a first cousin.[31]

**5. How can I help with their medical bills without paying gift tax?**

a. Payments to a person providing medical care (as defined by I.R.C. §213(d)) to the individual for such medical care is exempt.[32]

b. Payments to the hospital or clinic providing such care are included in the exclusion; however, if the donor pays the donee directly to reimburse the donee for previous payments[33] or insurance later reimburses the donee, the donor's payment will be treated as a taxable gift outside of the medical exclusion.[34]

**6. What if I want to make a gift to my spouse?** Gifts to a spouse can qualify for a 100% marital deduction.[35] Although such gifts do not automatically come to mind in a family wealth transfer setting, gifts to a spouse may satisfy a number of wealth planning objectives. Some of the considerations include the following:

a. **Estate Equalization.** If the taxable estate of the less wealthy spouse is significantly less than the estate tax applicable exclusion, a transfer from the wealthier spouse to the less wealthy spouse can provide the spouse with sufficient property to fully capture that spouse's exclusion. In 2009, for example, a spouse with $3,500,000 will avoid estate tax assuming no prior taxable gifts.[36] A lifetime transfer in trust can qualify for the QTIP election, providing inclusion in the estate of the transferee spouse while allowing the transferor spouse to designate the remainder beneficiaries.[37]

b. **Basis step up.** If a cost basis step up is important for income tax purposes, a lifetime transfer of appreciated property to a spouse whose life expectancy will likely fall shorter than the mortality tables can permit a step up in basis for income tax purposes whether or not the property returns to the transferor spouse.[38] However, this benefit would only be available to the transferor spouse who receives the property back from the transferee spouse if the transferee spouse lives more than one year from the date of the transfer of the property by gift.[39]

c. **Creating valuation adjustments with spousal transfers.** Discounts for lack of marketability and for minority interest can substantially reduce valuations for gift and estate tax purposes. Dividing the membership interests in entities such as limited liability companies, corporations, family limited partnerships and the like between spouses can provide each spouse with a 50% interest. Since such an interest neither controls the entity nor is

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[31] I.R.C. Secs. 529(c) (5) (B) and §152(d)(2).
[32] I.R.C. Sec. 2503(e)(2)(B).
[33] Regs. Sec. 25.2503-6(c),
[34] I.R.C. Sec. 2503(e)(2)(B) and Regs. Secs. 25.2503-6(b)(1)(ii), (b)(3), (c).
[35] I.R.C. Sec. 2523.
[36] I.R.C. Sec. 2010(c).
[37] I.R.C. Sec. 2056(b)(7).
[38] I.R.C. Sec. 1014(a)(1).
[39] I.R.C. Sec. 1014(e).

generally as marketable as the underlying asset, such a division offers an opportunity to discount the value of the 50% interest in the estate of the first spouse to die.[40] For purposes of the discount, it is irrelevant that the interest passes to family members.[41] The creation of an entity and an equal division of interests in that entity can, therefore, create an opportunity to discount the value of the interests at the death of both spouses. A gift of the spouse's interest to children or grandchildren, of course, is also a gift of an interest that is likewise less marketable than 100% ownership of the underlying assets and is of a minority interest, both of which would permit further discounts. Gifts of these separate interests may be desirable for funding separate grantor retained trusts, charitable trusts, intentionally defective grantor trusts or other techniques that require contributions or funding with specific and separate interests in property.

d. **General power of appointments in a revocable living trust.** The richer spouse grants the less wealthy spouse a general power of appointment over the richer spouse's assets transferred to the richer spouse's revocable living trust equal to the unused applicable exclusion amount. If the richer spouse predeceases the poorer spouse, an amount equal to the applicable exclusion amount is set aside for the poorer spouse in a marital trust. At the poorer spouse's death, that amount passes estate tax free. If the poorer spouse predeceases the richer spouse, the poorer spouse's estate will include the assets of the richer spouse over which the poorer spouse holds a general power of appointment and will be excluded from estate taxation by the applicable exclusion amount. If the power lapses, the amount passes to a bypass trust for the richer spouse. This technique has been approved by four private letter rulings.[42]

**C. Generation Skipping Gifts.**

**1. If I make outright gifts that skip a generation, how does the generation skipping transfer tax ("GST") apply and under what circumstances might I encounter that tax?** The GST, a very complex tax system, taxes transfers of property the beneficial ownership of which will be enjoyed by successive younger generations. Generally, outright gifts or gifts in trust will be subject to the GST if the recipients are in a generation that is two or more below the donor's generation (grandchildren and their descendants for example although the imposition of the GST is not dependent upon membership in the same family). The GST essentially taxes transfers of property as if that property was included for estate tax purposes in each successive generation. Where donors use trusts to benefit successive younger generations with gifts of property that will not, by the terms of the trust, be taxed at the death of each successively younger generation, the GST "substitutes" a tax that attempts to pick up the revenue when the estate tax would have otherwise applied. The tax can also apply where donors make outright gifts directly to donees that are two or more generations below the donor. The rate of tax is the highest marginal rate of tax that would have applied under the estate tax system (currently 45%).[43]

**2. Skip and non-skip persons.** A skip person is a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor (e.g. a grandchild), or a trust if all interests in the trust are held by skip persons (e.g., a trust for

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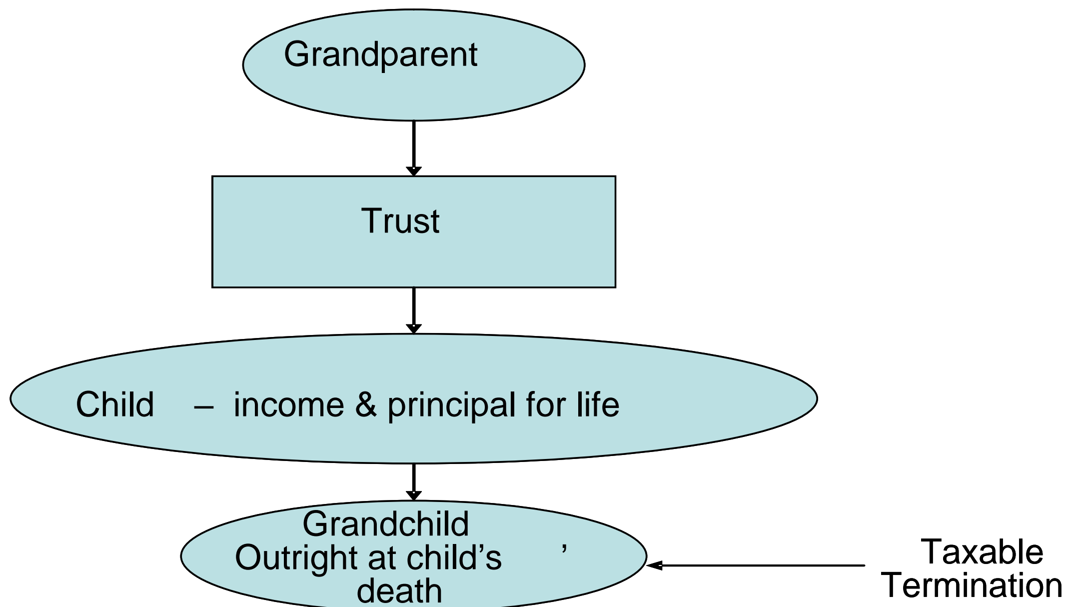
[40] and Regs. Sec. 20.2031-2(f) provides that one of the factors in determining the value of shares of unlisted stock is "the degree of control of the business represented by the block of stock to be valued."
[41] Rev. Rul. 93-12, 1993-1 C.B. 202.
[42] Ltr. Ruls. 200101021 (Jan. 8, 2001), 200210051 (Mar. 8, 2002), 200403094 (Jan. 16, 2004) and 200604028 (Jan. 27, 2006).
[43] I.R.C. Sec. 2001(c) which sets the GST tax rate at 45% in 2007-2009.

grandchildren), or if there is no person holding an interest in the trust and at no time after a transfer may a distribution (including a distribution on termination) be made from such a trust to a non-skip person (e.g., a trust is not a skip person where both C and GC are current beneficiaries because the C beneficiary is not a skip person. Upon C's death, leaving only GC, the trust becomes a skip person). A non-skip person is any person who is not a skip person.[44] For individuals who are not lineal descendants, assignment to generations is determined by specified number of years in age with respect to the age of the donor. A person born not more than 12.5 years after the birth of the donor is within the same generation as the donor. A person born more than 12.5 years after the birth of the donor but not more than 37.5 years after the birth of the donor is deemed to be one generation down from the donor. Similar rules apply for a new generation every 25 years[45]. A special "move up" rule applies if at the time the gift or estate tax event occurs the parent of the recipient of the benefit predeceases the event. For example, if at the time of the grandparent's death, the grandchild's parent (child of the grandparent) predeceased the grandparent, the grandchild moves up a generation and is not considered a skip person.[46]

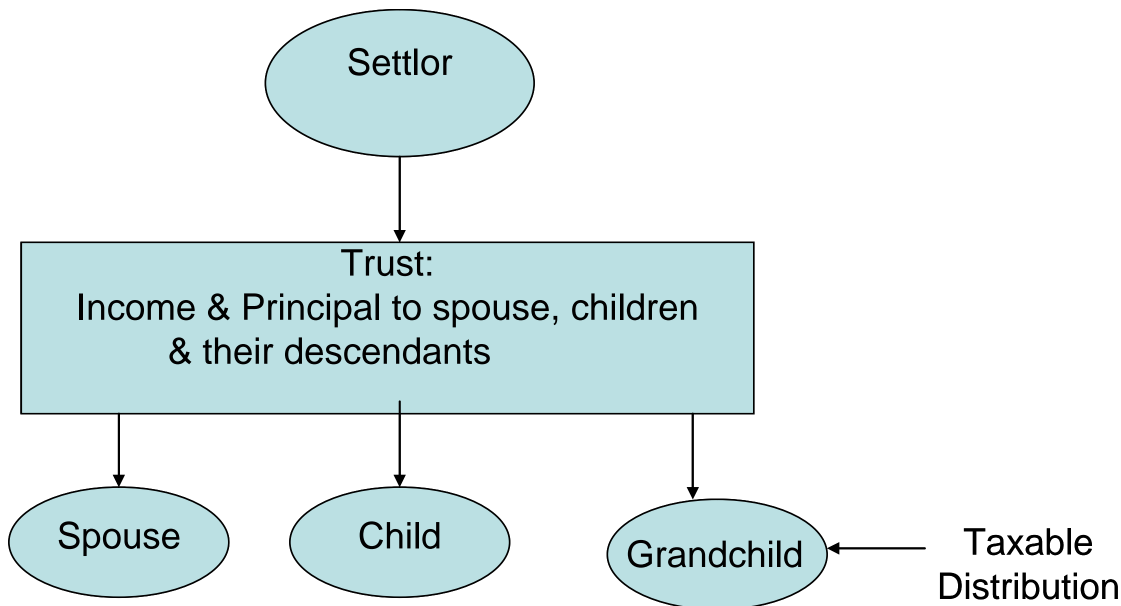
**3. The GST tax applies to three kinds of taxable transfers:**

a. **Taxable terminations.** This taxable event occurs when an interest in property held in trust terminates unless a non-skip person immediately after the termination has an interest in the property in trust or at no time after such termination may a distribution (including a distribution on termination) be made from such trust to a skip person.[47] For example:

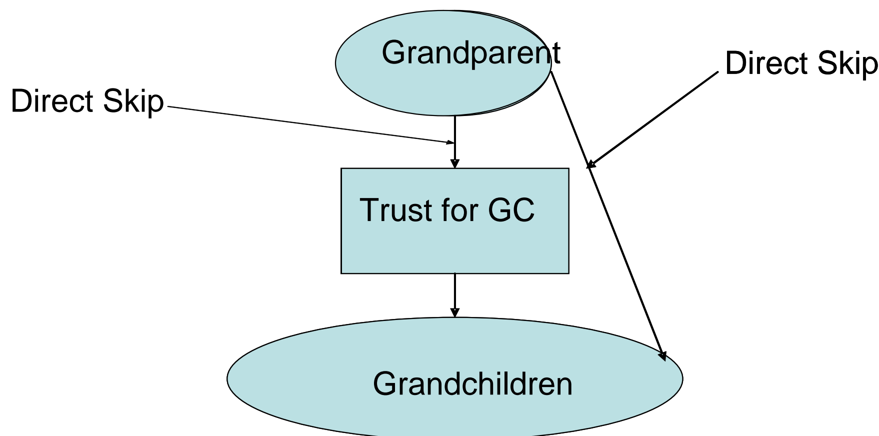



[44] I.R.C. Sec. 2612(a).
[45] I.R.C. Sec. 2651(d).
[46] I.R.C. Sec. 2651(e)(1).
[47] I.R.C. Sec. 2612(a).

b. **Taxable distributions.** A taxable distribution occurs when any distribution from a trust to a skip person is made other than a taxable termination or a direct skip.[48] For example, Settlor establishes a trust to spray income and/or principal to spouse, children and children's descendants:




c. **Direct Skips.** A direct skip occurs when a transfer subject to a gift or estate tax of an interest in property is made to a skip person.[49] For example and outright gift or a gift in trust to a grandchild or more remote person is a direct skip:




### 4. How does the GST affect annual exclusion gifts?

a. **Outright to donee.** These gifts are not subject GST tax as an exception to the direct skip rule. If the outright gift qualifies for the annual gift tax exclusion,[50] it

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[48] I.R.C. Sec. 2612(b).
[49] I.R.C. Sec. 2612(c).
[50] I.R.C. Sec. 2503(b).

also qualifies for an exemption from the GST.[51] GP gifts $10,000 outright to GC.

b. **Tuition and medical gifts.** If the gift for tuition or medical care qualifies for the gift tax exclusion,[52] it also qualifies for an exemption from the GST.[53] GP pays $30,000 tuition to the university or pays $20,000 hospital bill for the GC.

c. **Trap in Crummey trusts.** Crummey withdrawal powers are often granted in irrevocable trusts, most commonly in life insurance trusts, to avoid classification as a gift of a *future* interest. By providing the power holder with a withdrawal right for a period of time following the transfer of property to the trust, the property transfer qualifies as a *present* interest and for the annual exclusion. However, the transfer is subject to the GST tax absent careful drafting.[54]

**5. What if I want to give outright gifts to skip persons (two or more generations below me) in excess of the annual, tuition and medical exclusions?** See discussion below in Paragraph D.2.

## D. Lifetime Exemption Gifts.

**1. What if I want to give gifts to children or grandchildren (whose parents have predeceased me) that exceed the annual, tuition and medical exclusion?**

Such gifts will be subject to gift tax and will require the use of gift tax applicable exclusion (lifetime gift tax exemption) to avoid payment of gift tax. Cumulative gifts that exceed the annual, tuition or medical exclusions are subject to gift tax and gift tax return filing requirements. Each person must utilize their lifetime gift tax exclusion of $1,000,000[55] for gifts in excess of the annual, tuition and medical exclusions.[56] Oregon does not impose a gift tax on lifetime gifts. A gift to a grandchild whose parent predeceased the date of the gift is not subject to the GST tax since there is no gift to a skip person due to the "move up" rule.[57] Cumulative gifts that exceed the lifetime gift tax exclusion of $1,000,000 are taxed at progressive rates under the unified rate schedule which applies rates of 39% to gifts just over $1,000,000 to 45% on gifts over $2,500,000.[58] The goal of the assignment of GST exemption to a gift is to achieve an inclusion rate of "zero." For example, a donor allocates their $1,000,000 GST exemption to a lifetime give of $1,000,000 to a trust that is subject to the GST tax. The applicable fraction equals the amount of the GST allocation over the amount of the gift.[59] The inclusion ratio equals

[51] I.R.C. Sec. 2642(c)(1) & (3).
[52] I.RC. Sec. 2503(e).
[53] I.R.C. Secs. 2611(b) and 2642(c)(1) & (3).
[54] I.R.C. Sec. 2642(c)(2) A gift in trust equal to the annual exclusion is not automatically exempt from GST tax even with Crummey powers. See also I.R.C. Sec. 2632(c) where the GST exemption is automatically allocated to such gifts unless elected out of such treatment on a timely filed gift tax return.
[55] I.R.C. Sec. 2505.
[56] Rev. Rul. 79-398, 1979-2 C.B. 338.
[57] I.R.C. Sec. 2651(e)(1).
[58] I.R.C. Sec. 2001.
[59] I.R.C. Sec. 2642(a)(2).

one minus the applicable fraction.[60] In this example the inclusion ratio is zero. $(1 - \frac{1{,}000{,}000}{1{,}000{,}000} = 0)$

**2. What if these gifts are made to skip persons or to trusts which will become subject to the GST tax?**

Each individual has a generation skipping transfer tax exemption that may be applied to exempt the property transfer from the GST tax. In 2007 and 2008, that exemption is worth $2,000,000. It increases to $3,500,000 in 2009.[61] The full amount of the exemption is available for allocation to GST transfers at death. Thus, a transfer of an estate worth $2,000,000 to a grandchild at death may fully escape both estate and GST tax. Note, however, that the applicable exclusion amount for gift tax purposes sits at a lower threshold equal to $1,000,000[62] less the amounts of previously taxable gifts.[63] Although gifts exceeding that lower amount may be exempt from GST tax, a gift tax will be payable on the property transfer value exceeding $1,000,000. A donor may allocate GST exemption to taxable gifts made to skip persons or to trusts subject to the GST tax. For lifetime gifts, the maximum GST exemption equals the "applicable exclusion amount" that exists in the year of the gift.[64] A donor would pay gift tax on cumulative gifts that exceed $1,000,000 but would only begin paying GST tax on the amount of gifts exceeding the GST exclusion amount assuming that the donor allocated the maximum GST exemption to the gift. A gift in 2007 (assuming no previous taxable gifts) of over $2,000,000 to a skip person or trust that was subject to the GST tax would generate two levels of tax, i.e., the gift tax on amounts over $1,000,000 and GST tax on the amount gifted over $2,000,000. The timing on payment of GST tax, however, depends upon when the taxable event occurs. On direct skips, the GST tax is imposed at the time of the taxable transfer and the transferor must report and pay the tax with a timely filed gift tax return Form 709.[65] The transferee is liable for reporting and paying the tax if a taxable distribution is paid from a trust that is subject to GST tax on the distribution.[66] The trustee is liable for reporting and paying the GST tax when a taxable termination occurs.[67] Automatic allocation of GST exemption will occur under certain circumstances for GST taxable transfers.[68] An election out of the automatic allocation rules can be made on a timely filed gift tax return.[69]

**3. Oregon deathbed gifts.**

A lifetime gift may be advisable for an individual whose gross estate is just shy of $2,000,000 as their estate would be exempt from federal estate tax in 2007 but would be subject

[60] I.R.C. Sec. 2642(a)(1).
[61] I.R.C. Secs. 2631 and 2010(c).
[62] I.R.C. Sec. 2505(a)(1)
[63] I.R.C. Sec. 2505(a)(2)
[64] I.R.C. Sec. 2631(c), as amended by EGTRRA, P.L. 107-16, §521 (cross-referencing §2010(c)). This amount is: $1,500,000 for 2004 and 2005; $2,000,000 for 2006, 2007 and 2008; and $3,500,000 for 2009.
[65] I.R.C. Sec. 2603(a)(3).
[66] I.R.C. Sec. 2621(a).
[67] I.R.C. Secs. 2622 and 2621(a).
[68] I.R.C. Sec. 2632(b)(1).
[69] I.R.C. Sec. 2632(b)(3) and Regs. Sec. 26.2632-1(b)(1)(i).

to Oregon Inheritance Tax due to the lower state exemption of $1,000,000.[70] Since Oregon imposes no gift tax, a lifetime transfer of up to $1,000,000 (assuming no previously taxable federal gifts) will be free of federal gift tax and will remove the asset from the Oregon estate for inheritance tax purposes, potentially saving almost $100,000 of Oregon Inheritance Tax.[71] As you can see from the following table, Oregon's exemption, unlike the federal applicable exclusion amount capped out last year and will not increase absent legislative changes:

| Year of Death | Federal Exemption | Oregon Exemption |
|---|---|---|
| 2003 | $1,000,000 | $700,000 |
| 2004 | 1,500,000 | 850,000 |
| 2005 | 1,500,000 | 950,000 |
| 2006 | 2,000,000 | 1,000,000 |
| 2007 | 2,000,000 | 1,000,000 |
| 2008 | 2,000,000 | 1,000,000 |
| 2009 | 3,500,000 | 1,000,000 |
| 2010 | Unlimited | 1,000,000 |
| 2011 | 1,000,000 | 1,000,000 |

The Oregon inheritance tax resulting from the growing gap between the federal exemption and the capped Oregon exemption is calculated as follows[72]:

| Year | Federal Exemption | Oregon Exemption | O Tax on the GAP Amount |
|---|---|---|---|
| 2005 | $1,500,000 | $950,000 | $64,400 |
| 2006 | $2,000,000 | $1,000,000 | $99,600 |
| 2007 | $2,000,000 | $1,000,000 | $99,600 |
| 2008 | $2,000,000 | $1,000,000 | $99,600 |
| 2009 | $3,500,000 | $1,000,000 | $229,200 |
| 2010 | Unlimited | $1,000,000 | N/A – Oregon Tax Only – No GAP |
| 2011 | $1,000,000 | $1,000,000 | 0 |

**E. Highly leveraged gifts with case studies.**

**1. LLCs – Limited liability companies.**

a. **Facts.** The Trumps operate many of their real estate holdings in the form of limited liability companies ("LLCs"). They have discussed using this form of entity for owing and transferring interests in their commercial real property to their children and grandchildren. They wish to use the property but want to reduce their estate taxes while protecting the property from claims from son and daughter-in-laws and third party creditors.

[70] I.R.C. Sec. 2010 which provides a $2,000,000 exemption in 2006 while ORS 118.160 which exempts estates from filing unless the federal estate tax return is required to be filed and the gross estate exceeds $1,000,000. See also ORS 118.160(1)(b)(D) for Oregon.

[71] 118.010(2) and I.R.C. Sec. 2011 as amended and in effect on December 31, 2000

[72] 118.010(2) and I.R.C. Sec. 2011 as amended and in effect on December 31, 2000

b. **Technique.** The Trumps form an LLC entitled "The Trump Family LLC" and deed the property to the entity. Mr. and Mrs. Trump each receive a 50% member interest in the LLC. In addition, they transfer cash to the property sufficient to establish an endowment fund to generate income for maintenance and repair of the property if earnings are insufficient. They execute a written operating agreement that restricts transfer of ownership interests other than to "permitted transferees" at death (defined as lineal descendants and trusts for spouses whose interests are held in trust for life, remainder to lineal descendants). The operating agreement includes other provisions governing the ownership, use and operation of the entity and the property. The Trumps later transfer membership interests in the LLC to their children and grandchildren. Their attorney explains that the LLC can provide a measure of protection against creditor claims.[73] Creditors who successfully attach the membership interest of the debtor become mere assignees unless the members vote them into membership. As assignees, the creditor is entitled to distributions when and as made.[74] The deferral of distributions can be frustrating enough to creditors to nudge them into a significantly reduced settlement.[75] The Trump Family LLC can be established to have a perpetual existence, unlike trusts. Also, the operating agreement can be more easily amended by the members without resorting to court approval as may be required in a trust after the Settlor's death.

c. **Tax consequences.**

1) **To the senior Trumps.** The senior Trumps have formed and funded an entity on a tax free basis.[76] The LLC will receive the Trumps carry-over basis in the contributed property.[77] The Trumps' basis in the membership interests will equal their basis in the contributed property.[78] The transfer of membership interests to their children and grandchildren can qualify for annual exclusion gifts[79] as well as for lifetime applicable exemption equivalent gifts (up to $1,000,000 each for a total of $2,000,000 for Mr. and Mrs. Trump). GST exemptions can be allocated to the gifts to grandchildren if the gift value exceeds the annual exclusion.[80] As an added advantage, the gifts of minority interests in the LLC can qualify for valuation discounts due to lack of marketability and absence of control. These discounts can reduce the value of the gift by 25-40% or more. The retention of equal membership interests by the senior Trumps also provides the advantage of potential valuation discounts for estate and inheritance tax purposes at each of their deaths due to the lack of marketability and lack of control (each own a 50% interest upon formation of the LLC). The discount at death would not otherwise be available for outright ownership of the real property for

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[73] ORS 63.165 and 63.175

[74] ORS 63.249(3)

[75] See however, *Movitz v. Fiesta Invs.,* LLC (In re Ehmann), 319 B.R.200, 206 (Bankr. D. Ariz. 2005) where the federal bankruptcy court in Arizona allowed a trustee in bankruptcy to dissolve and liquidate an LLC to satisfy creditors (case discussed in Steve Leimberg's Asset Protection Planning Email Newsletter – Archive Message #81, April 24, 2006, online at http://leimbergservices.com).

[76] I.R.C. Sec. 721(a)

[77] I.R.C. Sec. 723

[78] I.R.C. Sec. 722

[79] PLR 9131006, 8611004 and TAM 199944003 which held the gifts to be present interests but see *Hackl v. Comm'r.*, 2002 U.S. Tax Ct., 118 T.C. 14 (2002) where the rights of the donee partners were too limited rendering the gifts ineligible for the annual exclusion due to failure to qualify as present interest gifts

[80] I.R.C. Sec. 2631(c). The GST exemption equals the applicable exclusion under I.R.C. Sec. 2010(c)-currently $2,000,000 for each of the Trumps

the husband and wife.[81]

2) **To the Junior Trumps.** The junior Trumps (children and grandchildren) receive a minority interest in the LLC. To the extent that the LLC generates income or loss (unless specially allocated to the member providing the capital contribution), the junior Trumps share in such items to the extent of the pro rata membership interest in the LLC.

d. **Risks and disadvantages**.

1) To the Senior Trumps.

The IRS may choose to include the entire value of the underlying property held by the LLC in their gross estates at their deaths depending upon the structure of the LLC and the degree of retained control. If the Trumps retain unrestricted access and use of the property, the IRS may argue that the entire underlying value of the real property held by the LLC should be included in their estate by arguing that the senior Trumps retained too much power over the possession or enjoyment of, or the right to the income from, the property.[82] If the Trumps act as managers and retain powers which are exercisable by them alone or in conjunction with others to control the right to designate the persons who shall possess or enjoy the property or the income there from to include the value of the underlying assets in their estates (the "swing vote problem"), the Service may attempt to include the entire value of the underlying asset.[83] Nevertheless, if properly structured, these risks can be minimized or eliminated. Also, the transfer of the vacation home to the LLC will preclude the senior Trumps from claiming exemptions from capital gains for sale of a principal residence if their ownership and use would otherwise qualify them for this exclusion equal to $500,000 as a married couple.[84] An annoying disadvantage for some families using LLCs can be the added legal and accounting burdens and expenses associated with annual corporate office filings and tax reporting.

2) To the Junior Trumps. Mostly the risks associated with the senior Trumps become risks assumed by the junior Trumps as their estates grow and become more exposed to death taxes. Operational integrity and attention to detail can reduce these risks.

**2. QPRTs – Qualified personal residence trusts.**

a. **Facts.** Mrs. Johnson, a widow in her 70s, spends the summer months in her Broken Top home in Bend, Oregon. She invites her only child, Megan, her husband Michael and their children, who live in Portland, to spend several long weekends and summer vacation weeks with her. Mrs. Johnson anticipates that she will likely move to an assisted living center sometime in five to seven years and would no longer wish to retain ownership. Megan and Michael have often expressed interest in Mrs. Johnson retaining the property for their future ownership as they would use the property year-round for recreation. Mrs. Johnson's attorney explained the benefits of using a QPRT to transfer ownership to her daughter.

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[81] Numerous cases provide support for minority and lack of marketability discounts, the discussion of which is beyond the scope of this outline

[82] I.R.C. Sec. 2036(a)(1).

[83] I.R.C. Sec. 2036(a)(2).

[84] I.R.C. Sec. 121.

b. **QPRT Technique**. Mrs. Johnson executes a trust for a term of seven years and deeds ownership of the property to herself as trustee. She retains the right to live and occupy the home for the term of the trust. During this time, Mrs. Johnson continues to pay the taxes, insurance and maintenance. Upon termination of the trust, she executes a deed from the trust to her daughter. Mrs. Johnson's attorney's started with the form of QPRT provided by the Internal Revenue Service making appropriate modifications.[85]

c. **Tax consequences to Mrs. Johnson.** Mrs. Johnson has gifted her residence to a grantor trust in which she retains a "qualified interest", i.e. a residence to be used as a personal residence.[86] She is entitled to all of the income and deductions of the trust as if she owned the home outright.[87] She has made a gift of the home to her daughter on a leveraged basis because the value of the gift of the home is substantially reduced to a present interest valuation due to the delayed distribution of the property to her daughter.[88] Although the gift fails to qualify for the annual exclusion, as the gift is a future, not present interest gift, her gift can be offset by the $1,000,000 exemption equivalent. She will have also effectively removed all of the appreciation on the Broken Top home during the seven year term of the trust as well. By way of illustration, here is the example:

| | |
|---|---|
| Fair Market Value of Home | $1,000,000 |
| Value of retained interest | 541,900 |
| Gift: Present Value of Remainder | 458,100 |
| Less: Lifetime gift tax exclusion | (458,100) |
| Net Gift: | $0.00 |
| Property value after 7 years (6% after tax) | $1,503,630 |
| Potential death tax saved (combined 50%) | $522,767[89] |

d. **Risks and disadvantages**. Unless Mrs. Johnson outlives the term of the trust, her estate will include the value of the home at her death.[90] Therefore, it would be best to set the term of the trust well within her life expectancy to take advantage of this leveraged gift. If she died before the seven year term ended at a time when the property had appreciated to $1,500,000, her estate and inheritance taxes on this asset would total approximately $750,000. Also, if she outlives the terms of the trust and wishes to use the home, she must pay a fair market value rent to her daughter for the use. The payment of rent by Mrs. Johnson, although not deductible by Mrs. Johnson and taxable to her daughter as income, does reduce Mrs. Johnson's taxable estate.

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[85] See Revenue Procedure 2003-42, June 9, 2003 and Appendix B.
[86] I.R.C. Sec. 2702(a)(3)(A) and Regs. Sec. 25-2702-5(c)
[87] I.R.C. Sec. 671 et. Seq. (grantor trust rules)
[88] I.R.C. Sec. 2072(a)(2)(B) and 7520
[89] NumberCruncher calculations
[90] I.R.C. Secs. 2036(a)(1) and (2)

### 3. Dynasty or perpetual trusts.

a. **Irrevocable trust.** The Marshalls plan to transfer property to a trust for their children, grandchildren and their descendants in a state that has modified or revoked the rule against perpetuities. Unlike Oregon[91], these states allow the duration of trusts to be perpetual (or for a very long term). Delaware is a popular choice to site perpetual trusts. Should the Marshalls wish to utilize lifetime annual exclusions and applicable gift tax credit, an irrevocable trust offers an opportunity to do so while providing for the management and use of the property. The Marshalls may designate their issue as well as the spouses of their issue as trust beneficiaries. They may grant powers of appointment to certain beneficiaries which permit the addition of other beneficiaries.

b. **Tax consequences.** The tax consequences for the Marshalls and their issue are the same as discussed above in Article II.D. above. The trust can be designed to qualify for annual exclusions provided it offers the beneficiaries a present right to withdraw contributions. Note, however, that gifts qualifying for the annual exclusion under I.R.C. 2503(b) do not automatically (without careful drafting) qualify for exemption from the GST tax. [92]

c. **Risks and disadvantages.** The language of the trust document controls and can be difficult to modify to adjust to changing circumstances. Under Oregon's Uniform Trust Code, the trust may be modified during the Settlor's life with the consent of the Settlor and all of the beneficiaries even if the modification or termination is inconsistent with a material purpose of the trust.[93] After the Settlor's death, the trustee and all of the beneficiaries may modify the trust provided the court finds that the modification is not inconsistent with a material purpose of the trust.[94] A termination requires the court to find that the continuance of the trust is not necessary to achieve any material purpose of the trust.[95] A termination may be more difficult than a modification because a spendthrift clause is considered a material purpose of the trust.[96] Duration of trusts will be limited by the rule against perpetuities. Trustees are fiduciaries. To the extent that family members serve as Trustees, they run the risk of charges of violating the duties of loyalty[97] and impartiality[98] to other beneficiaries if they favor themselves individually as to use, assessments, or other operational considerations over other trust beneficiaries. If the Settlor serves as trustee or appoints a third party trustee while reserving a right to appoint a successor trustee including herself, and the trustee holds any 2036–2038 powers, the Settlor runs the risk of inclusion of the property in their estates. Also, generation skipping transfer tax exemption allocation strategies should be considered for lifetime gifts into irrevocable trusts.[99] If the trust is established in another state, the law of that state must be examined and compared with Oregon's law to determine how the rules of the foreign state apply

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[91] See ORS 105.950 to 105.975. A nonvested property interest must vest when the interest is created not later than 21 years after the death of an individual alive at creation of the interest or the interest either vests or terminates 90 years after its creation.

[92] A gift in trust equal to the annual exclusion is not automatically exempt from GST tax even with Crummey powers (I.R.C. 2642(c)(2)). See also I.R.C. 2632(c) where the GST exemption is automatically allocated to such gifts unless elected out of such treatment on a timely filed gift tax return.

[93] ORS 130.200(1). This is a nonjudicial modification.

[94] ORS 130.200(2). This requires judicial involvement to modify.

[95] ORS 130.200(2).

[96] ORS 130.200(2) and (3)

[97] ORS 130.655

[98] ORS 130.660

[99] I.R.C. Secs. 2632 and 2642

to the trust.

**4. GRATs – Grantor retained annuity trusts.** A grantor retained annuity trust is used to transfer assets that are appreciating more rapidly than IRS imposed rates (the 7520 rate). The current IRS imposed rate on a GRAT is approximately 5.6%[100]. If assets appreciate at a greater rate, the appreciated value can be transferred to heirs at little, if any, gift tax cost. To remove the asset from the donor's estate, the donor must survive the term of the GRAT. See Article III.F.4 for an illustration.

**5. IDGTs –** An intentionally defective grantor trust (GRAT) combined with a sale of assets by the grantor to the trust provides an opportunity to use an interest rate (applicable federal rate, generally lower than the 7520 rate). Because the sale between the grantor and the grantor trust is considered by the Internal Revenue Service as a transaction that does not generate income tax recognition to the grantor, the technique provides a method of transferring appreciation in excess of the installment payments to heirs with less risk to the grantor of inclusion in the grantor's estate of the current value of assets should the grantor die during the term of the IDGT. See Article III.F.5 for an illustration.

### F. Adequate Disclosure Rules for Gift Tax Returns.

#### 1. Running of the Statute.

To begin the running of the three year statute of limitations, a gift must be adequately disclosed on Form 709, U.S. Gift Tax (and Generation-Skipping Transfer) Tax Return.[101]

#### 2. Adequate Disclosure.

Whether or not one chooses to file a gift tax return depends upon the chosen strategy (aggressive discounting of valuations, electing out of automatic GST exemptions, etc.). Although beyond the scope of this outline, adequate disclosure includes the following:

a. A description of the transferred property and any consideration received by the donor,

b. The identity of, and relationship between, the donor and each donee,

c. if the property is transferred in trust, the trust's EIN and a brief description of the terms of the trust (or a copy of the trust), and

d. Either a qualified appraisal or a detailed description of the method used to determine the fair market value of the gift.[102]

## III. PLANNING FOR FAMILY BUSINESS SUCCESSION

**A. Introduction.** Effective business planning involves thinking through an entrance,

[100] I.R.C. Sec. 7520. Commonly referred to as the "7520 rate" which is equivalent to 120% of the mid-term AFR rate.
[101] I.R.C. Sec. 6501(c)(9).
[102] Instructions, Form 709, page 4 and see also Regs. Sec. 301.6501(c)-1(e) and (f).

growth and exit strategy for the business.[103] As Stephen R. Covey says, "Begin with the end in mind."[104] How, therefore, will your client maximize their interest in their business assets for themselves and their family during the life cycle of their involvement in the business? This section explores the issues involved with planning for clients whose business interests represent a significant portion of their estate value. Will they pass the business on to family members? Will they sell to third parties? Will they merge with an acquiring business or seek an equity partner? Will they take the business to the public equity markets? Will they wish to benefit charity? These alternatives present their own set of unique planning opportunities and challenges.

**B. Case Study Facts.** James and Ellen Smith, Oregon residents for over 30 years, have operated Western Plumbing Supply, a successful business during this entire period. The business, based in Oregon, distributes plumbing supplies throughout the western United States from several warehouse/distribution centers in three western states. The business began as a C corporation. Sales have been growing at 10% annually. Employees share in ownership through an Employee Stock Ownership Plan (ESOP) which owns just under 10% of the company. Jim and Ellen own the balance of the corporate stock (joint with rights of survivorship) and one hundred percent of the real property (tenancy by entireties) together. The corporation leases each location from them.

One child, Sally, works in sales while the other, James, Jr., works with operations. Both are capable of assuming additional responsibilities and ultimately taking over the ownership and operation of the business. Jim and Ellen have been enjoying more time in Arizona recently and would like to begin planning an exit strategy involving transferring more responsibility to their children as well as to shift value from their estates. The corporate and real estate values have climbed significantly over the years, creating a substantial estate.

They have asked you, their primary advisor, to assemble legal, accounting, financial services and other appropriate advisors to assist in developing and implementing a plan to assist them in accomplishing their objectives. They have provided the following data for your review:

See next page:

[103] See Bruce R. Wright, *The Wright Exit Strategy (Wealth – How to Create It, Keep It and Use It)* (The Wright Company 1997) for a good discussion of this process.
[104] "Habit 2 -- Begin with the End in Mind", Covey, Steven R., The Seven Habits of Highly Effective People, Simon and Schuster, 1990.

**ASSETS**

| | |
|---|---|
| Cash | $175,000 |
| Securities and Notes (from Corp) | $550,000 |
| Primary Residence | $1,200,000 |
| Arizona Residence | $650,000 |
| Warehouses/Distribution Centers | $15,000,000 |
| Corporation | $30,000,000 |
| Personal Property | $150,000 |
| Retirement Plans | $1,750,000 |
| Total Assets | $49,475,000 |
| **Liabilities** | |
| Warehouse/DCs | $10,000,000 |
| **Net Worth** | $39,475,000 |

**Estimated Estate Tax**

**Estimate Based upon deferral of tax until death of survivor:** $18,797,570

Before jumping into possible solutions, let's back up a few years and see how their business and investments grew into this wonderful predicament!

**C. Why consider an Exit Strategy upon formation and organization of a business entity?** If you expect business success, why not form an entity at the commencement of business that provides a better tax outcome upon exit? Although success is not guaranteed by any means, if success is achieved as planned, certain entities offer better outcomes than others for an exit strategy.

**1. Money In (An "Entrance Strategy") and Money Out (A "Growth" and "Exit Strategy").**

a. **Tax considerations influencing the choice of entity**

1) Relative ease of transfer of money and property into most entities tax free

2) Tougher to withdraw money and property without tax

3) Taxation of business earnings – one level or two?

4) Payroll taxes

5) Sale of business – one  or two levels of tax?

b. **Distribution of profits and losses**

1) **Flexibility** - need for flexibility in providing for return on investment for capital, rewarding services, sharing growth in equity, etc.

2) **Family objectives** – planning for shift of ownership to family members and meeting their needs as passive, active or non-owners.  Here the Smiths have decided to begin to transfer ownership over time to the family while keeping options open for sale to third parties, especially to buyers of logistics operations or REITs for the warehouses (real estate investment trusts).

c. **Control**

1) Founders want to control until financially independence secured or ego allows transfer of control

2) Separation of control from equity ownership

d. **Management**

1) Centralized management is the usual choice for founders in any closely held entity

2) Outside directors/managers rare but useful in many businesses large or small

e. **Historical bias and trends in entity formation**

1) **C corporations** – The Smith's attorney choose this entity to begin their business as most businesses incorporated as C corporations 30 years ago.

2) **S corporations** – The company accountant finally convinced the Smiths to consider converting to an S corporation to avoid double taxation of earnings, to provide for a possible asset sale in the future at one level of tax and to allow diversification into other investments.  Most corporations formed today would likely elect S status commencing on incorporation to avoid built in gains, passive loss provisions and other tax traps.

3) **Limited Partnerships (LPs)** – a "pass through" entity with limited liability for limited partners with the disadvantage of liability for general partners (could be limited if the GP incorporated).

4) **Limited Liability Companies (LLCs)** - a modern, "pass through" entity with limited liability for members, even the managers.  The Smiths have been advised to transfer their warehouse/distribution centers into one or more LLCs to protect the assets from creditors, to permit lifetime transfers of membership interests during lifetime at a

substantial valuation discount, to maintain control, to provide for a source of income and to reduce estate tax upon death.

**D. Meeting the tiered objectives:**

**1. Founders**

a. Financial independence – planning doesn't happen until this is secured

b. retirement income assured

c. net worth independent of the business – principal of diversification

**2. Significance – moving from success to significance**

a. control – retained while value shifts to family

b. tax reduction

c. redirection of lifetime activities – often to nonprofit work or recreation

**E. Family**

**1.** participation in profits, equity build up and management

**2.** succession – tough due to psychological factors, perceived "fairness", complexity of planning and indecision

**F. Legacy**

**1.** beyond "enough" – How much is "enough" and what to do with what you have when you have arrived

a. taxable distributions/transfers v. tax favored to charity – the choice after meeting the above objectives

**G. Application of Choice of Entity and Affect on Transactions to the Smith Family**

**1. The Seven Choices**

a. Sole Proprietorship - simple but dangerous

b. Corporation (S & C) - C moving to S

c. Partnerships

1) General – why would they use an entity with full exposure?

2) Limited – better but why have exposure as a general partner? Even if the GP is an incorporated entity, why add another layer of complexity?

3) LLC – why not? This is today's entity of choice for business, real estate or investment entities for liability protection and tax efficiency.

4) LLP – not applicable to the Smiths. In Oregon, this entity is available to certain professionals or for real estate used in conjunction with the professional practice

**H. Fitting the Transaction to the Objective**

**1.** Transfer to family – most entities can be transferred to family members over time through transfers of interests in the entity.

**2.** Sale to unrelated third parties – most buyers want to buy assets, not stock or membership interests.

**3.** Merger, acquisition and equity partners – occasionally "rollups", stock for stock mergers or acquisitions and capital infusions for existing corporate entities.

**4.** Going Public/IPOs – C corporations still preferred entity

**I. Tools Used in the Smith Transaction**

**1. ESOP**

a. Company benefit – fund retirement plan with stock while preserving cash.

b. Employee benefit – participate in growth of company and sell stock back to company upon retirement

c. Owner benefit – partial tax-deferred sale to ESOP and reinvestment into diversified portfolio as part of the "exit strategy". This was started before the Smith's children became active in the business.

d. C or S corporations may use ESOPs

**2. Gifts of interests in operating entity and real estate**

a. **Control and marketability**

1) **Control follows stock** – consider recapitalization into voting and non-voting stock in the operating entity (permitted in both C and S corporations). This may broaden the number of potential donees (spouses of children, grandchildren and their spouses) for both annual exclusion and exemption equivalent gifts without shifting control to this expanded group

b. **S Election** – an S election can provide significant benefits

including reducing taxes due to a single level of tax, providing cash flow to family, avoiding "built in gains" within the corporation upon sale of assets (after the required 10 year period or anytime if an S election is made immediately upon incorporating), permitting numerous "freeze" techniques described below and broadening stock ownership, especially when voting and nonvoting shares are authorized, issued and gifted. Here the Smiths can gift to spouses and children of their children.

c. **Real estate** – form LLC and fund with real estate and assign lessor's interest in lease to LLC. Holding an interest in this asset provides cash flow while gradual withdrawal from operating entity accomplished. Gifts of membership interests enjoy valuation discounts for lack of control and marketability while cash distributions can provide for needs of other family LLC members

d. **Analysis of specific tools to transfer interests in the above entities to family.** The Smiths want to start by transferring value in the warehouse/DCs and operating entity to their children.

1) **LLC formation and transfer of membership interests**. The Smiths can convey their warehouse/DCs to one or more LLCs, severing the tenancy by entireties and receiving an equal 50% interest each in the entity. That transfer alone can open the door to valuation discounts on the death of either or both parent since neither would own a majority interest in an entity in which the interests are difficult to market. The net worth of the real estate totals $15,000,000. James and Ellen could give $4,000,000 of value tax free if discounted 50%. The discounted value of $2,000,000 could be given tax free leaving James and Ellen each with $11,000,000 ($15M-$4M) to divide between them equally. James and Ellen can continue to manage the LLC and receive benefits from the cash flow. Note, however, that one should pay attention to recent cases attacking LLC strategies involving arguments of gift on formation, retention of interests (especially income) and too much control under the facts that can defeat this planning. The gift and division of the remainder could save substantial estate tax due to the same discounts for lack of marketability and control.

e. **Installment sale of stock in operating entity.**

1) Conservative and safe approach – tried and true. The sale of a minority interest in a closely held entity will also enjoy valuation discounts so that a greater percentage of the business may be sold thus removing the discounted value and future growth from the parent's estate. The sale, in effect, "freezes" the value of the portion of stock sold in the estate of the parents while future growth in value accrues to the children thus eliminating estate tax on the future growth element of the stock

2) rate of interest for term of purchase (short, mid or long term, e.g. long-term annual AFR 4.9% in May 2007)[105]

3) S stock – cash flow to children for purchase of parent stock

4) Children pay tax on prorata share of earnings of S corporation and pay parent with after tax dollars

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[105] Rev. Rul. 2007-29, Table 1.

5) Parents pay tax on interest at ordinary income tax rates and on capital gain at capital gain rates

6) See spreadsheet illustration for Seller attached – problems: expensive from an income tax and cash flow perspective, unpaid balance is subject to IRD (income in respect of a decedent) at death and the note balance is an asset of the parents estate

**3. GRAT (Grantor Retained Annuity Trust) – another method to transfer growth to children at less expense than an installment sale**

a. The parent creates an irrevocable trust for the benefit of the children

b. The parent gifts stock to the trust and retains an annuity for the term of the trust

c. The transfer of stock in return for an annuity results in an exchange of value. The gift is measured by the value of the stock less the value of the annuity

d. The value of the annuity (calculated by using the IRS "Section 7520" or "120% Mid-Term AFR" rates) may be adjusted to reduce the value of the gift to a minimal amount

e. The exchange is not considered a "sale" for income tax purposes since the GRAT is considered a "grantor trust", treating the grantor as owner – resulting in a transaction with oneself, ignored for income tax purposes

f. S corporation distributed income provides cash flow to pay the annuity

g. grantor pays tax on the amount of S corporation income in the trust not on the capital gain in the stock exchanged

h. In the event of inadequacy of income from S corporation distributions, shares of stock may be returned to the grantor as an in-kind annuity payment

i. The children become owners of the stock upon termination of the trust without further tax consequence

j. The children receive the appreciated stock less the Section 7520 rate of interest paid, the principal portion of the GRAT payments (paid in cash or in kind, i.e. shares used as an in-kind payment towards the annuity)

k. Risk – if the grantor dies before the termination of the trust, the entire trust corpus (including all appreciation) is included in the grantor's estate as if the GRAT was never used

l. See spreadsheet Schedule 2.

### 4. Sales to an IDGT (Intentionally Defective Grantor Trust)

a. Like the GRAT, the parent creates an irrevocable trust for the benefit of the children

b. The trust is a grantor trust due to a special administrative power to substitute assets of equal value for assets within the trust. The IRS has ruled that a transaction between the grantor and the grantor trust is not subject to income tax recognition.[106]

c. The IDGT design avoids inclusion of trust assets in the Smith's estate at death at their then fair market value. The IRS has ruled that the IDGT will not be included in the gross estate of the grantor at death under I.R.C. 2036 as long as the grantor is obligated to pay income tax on the income taxed to the IDGT without any reimbursement from the trust.[107]

d. The Smiths will sell stock to the IDGT on the installment method at the lowest interest rate required by the IRS (this transaction is then considered as an "arms-length" sale without any gift element)

e. Discounts for lack of marketability and lack of control apply

f. An installment note is issued from the trust to the Smiths for the sale of the stock

g. Cash flow from distributed S corporation earnings will service the payments of interest and principal (or if insufficient to fully amortize the note, part of the principal can be deferred and the children can obtain third party financing to loan to the trust to cash out the note just before the end of the term). The parents pay tax on the S corporation earnings for stock sold to the trust as they are deemed owners of the stock while held in the trust (grantor trust status)

h. The interest and principal payments are nontaxable to the Smiths due to the grantor status of the trust – a tax-free sale of stock to your trust!

i. To provide financial credibility to the trust as a purchaser, guidelines suggest that the trust be funded with approximately 10% of the note balance in advance. This would normally be a taxable gift of a future interest

j. Upon payment of the note in full, the trust terminates and the stock is distributed to the Smith children. They receive the appreciation of the stock offset by the interest paid.

k. Unlike the GRAT, a death during the term of the trust does not bring the whole value back into the decedent's estate; only the note balance is included, not the stock. However, tax treatment of remaining payments on the note for income tax may become taxable to the estate since grantor trust status terminates upon death of seller/trustor. Whether or not tax on the deferred gain is reportable as post-death payments are made or whether they are

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[106] Rev. Rul. 2004-64, 2004-27 I.R.B. 7.
[107] Ibid.

not taxable due to a stepped up basis in the stock is unclear. Nevertheless, the appreciation element is removed from the estate of the decedent, a better result than in the GRAT.

l. See spreadsheet 3 below

m. This technique, however, is not for the faint of heart as it, unlike the GRAT, does not find its authority under the Internal Revenue Code but under letter rulings and case law.

### 5. ILITs/WRTs

a. An irrevocable life insurance trust (ILIT) may provide additional funds for payment of estate tax without inclusion of the proceeds in the decedent's estate

b. An ILIT may also serve as a "wealth replacement trust" ("WRT") to provide a tax-free benefit to heirs whose inheritance in the family business was distributed by their parents to siblings active in the business

## IV. CONCLUSION

Much can be done with a combination of tools, techniques and strategies to maintain the parent's financial independence and control while shifting value from their estate to their children to lower gift and estate taxes. The success of wealth transfer and business succession relies on planning with the family's advisor team and family members. This process should be viewed as an ongoing strategy involving periodic meetings, reviews and modifications where necessary. It is anything but transactional and should be viewed as a marathon not a sprint.

Schedule 1

| FACTORS | | % | | INSTALLMENT SALE | | |
|---|---|---|---|---|---|---|
| Total Shares | 3,850,000 | 100 | | Principal | $5,211,000 | |
| Jim,Sr.' Shares | 3,525,675 | 91.6 | | Int. Rate | 4.9% | |
| | | | | | | |
| Value per share Pre- | | | | | | |
| Discount (5.79/.74) | $7.82 | | | Ann. Pmt. | $729,875 | |
| Value per share Post 26% | | | | Total Pmt | | |
| Discount | $5.79 | | | 9 Yrs | 6,568,875 | |
| Total Company Value | | | | | | |
| (3,850,000X7.82) | $30,107,000 | 100 | | | | |
| Jim, Sr.'s Current Value | | | | | | |
| (3,525,675X$7.82) | $27,570,778.50 | 91.6 | | Principal | $5,211,000 | |
| (assumes no discounting since this is a majority | | | | Interest | $1,357,873 | |
| block. Ignores blockage discount due to | | | | | | |
| possible premium for majority ownership) | | | | Taxes: | | |
| | | | | On Princi | | |
| Shares in Play | $900,000.00 | 23.4 | | Fed @15% | $781,650 | |
| Valuation/Share | $5.79 | | | OR @ 7.65% | $398,642 | |
| Discounted Value | $5,211,000.00 | | | Subtotal | $1,180,292 | |
| Value/Share - No Disc | | | | On Int | | |
| @ 23.4% of Company | | | | Fed @35% | $475,255 | |
| (900,000X7.82) | $7,038,000.00 | | | OR @ 5% | $67,894 | |
| | | | | Subtotal | $543,149 | |
| Cash Analysis | | | | Total Tax | $1,723,441 | |
| Total Earnings | $5,400,000.00 | | | | | |
| Distribution @62% | $3,348,000.00 | | | To Jim, Sr. | **4,845,434** | |
| Dist on 23.4% of Stk | $783,432.00 | | | S Inc.Taxed to Children | See Schedule 4 | |
| | | | | Gift | 0 | |

Schedule 2

| **FACTORS** | | **%** | | **INSTALLMENT SALE** | | | **GRAT** |
|---|---|---|---|---|---|---|---|
| Total Shares | 3,850,000 | 100 | | Principal | $5,211,000 | | $5,211,000 |
| Jim,Sr.' Shares | 3,525,675 | 91.6 | | Int. Rate | 4.9% | Int. Rate | 5.60% |
| | | | | | | | |
| Value per share Pre- | | | | | | | |
| Discount (5.79/.74) | $7.82 | | | Ann. Pmt. | $729,875 | Annuity | $752,849 |
| Value per share Post 26% | | | | Total Pmt | | Total Pmt | |
| Discount | $5.79 | | | 9 Yrs | 6,568,875 | 9 Yrs | $6,775,644 |
| Total Company Value | | | | | | | |
| (3,850,000X7.82) | $30,107,000 | 100 | | | | | |
| Jim, Sr.'s Current Value | | | | | | | |
| (3,525,675X$7.82) | $27,570,778.50 | 91.6 | | Principal | $5,211,000 | | |
| (assumes no discounting since this is a majority | | | | Interest | $1,357,873 | | |
| block. Ignores blockage discount due to | | | | | | | |
| possible premium for majority ownership) | | | | Taxes: | | | |
| | | | | On Princi | | | |
| Shares in Play | $900,000.00 | 23.4 | | Fed @15% | $781,650 | | 0 |
| Valuation/Share | $5.79 | | | OR @ 7.65% | $398,642 | | 0 |
| Discounted Value | $5,211,000.00 | | | Subtotal | $1,180,292 | | |
| Value/Share - No Disc | | | | On Int | | | |
| @ 23.4% of Company | | | | Fed @35% | $475,255 | | 0 |
| (900,000X7.82) | $7,038,000.00 | | | OR @ 5% | $67,894 | | 0 |
| | | | | Subtotal | $543,149 | | |
| Cash Analysis | | | | Total Tax | $1,723,441 | | 4,548,960 |
| Total Earnings | $5,400,000.00 | | | | | | |
| Distribution @62% | $3,348,000.00 | | | To Jim, Sr. | **4,845,434** | To Jim, Sr. | **$2,226,684** |
| Dist on 23.4% of Stk | $783,432.00 | | | S Inc. Taxable to Children | See Schedule 4 | S Inc. Taxable To Jim | |
| | | | | Gift | 0 | Gift | $2.68 |

Schedule 3

| **INSTALLMENT SALE** | | | **GRAT** | | **IDGT** |
|---|---|---|---|---|---|
| Principal | $5,211,000 | | $5,211,000 | | $5,211,000 |
| Int. Rate | 4.9% | Int. Rate | 5.60% | | 4.62% |
| | | | | | |
| | | | | | |
| Ann. Pmt. | $729,875 | Annuity | $752,849 | Ann. Pmt. | 0 |
| Total Pmt | | Total Pmt | | Interest only @4.9 | $216,673 |
| 9 Yrs | 6,568,875 | 9 Yrs | $6,775,644 | 9 Yrs | $1,950,057 |
| | | | | | |
| | | | | | |
| | | | | | |
| Principal | $5,211,000 | | | Prin @ end of 9 yrs (balloon pmt) | $4,689,900 |
| Interest | $1,357,873 | | | | 1,950,057 |
| | | | | Total Pmt to Jim | 6,639,957 |
| Taxes: | | | | Covered by pmt | |
| On Princi | | | | To Trust of: | 0 |
| Fed @15% | $781,650 | | 0 | 7,050,888 | 0 |
| OR @ 7.65% | $398,642 | | 0 | | 0 |
| Subtotal | $1,180,292 | | | | |
| On Int | | | | | |
| Fed @35% | $475,255 | | 0 | | 0 |
| OR @ 5% | $67,894 | | 0 | | 0 |
| Subtotal | $543,149 | | | | |
| Total Tax | $1,723,441 | | 4,548,960 | S inc. tax | 4,548,960 |
| | | | | | |
| To Jim, Sr. | **4,845,435** | To Jim, Sr. | **$2,226,684** | To Jim, Sr. | **$2,090,997** |
| S Inc. Taxable to Children | See Schedule 4 | S Inc. Taxable to Jim | | S Inc. Taxable to Jim | |
| Gift | 0 | Gift | 0 | Gift | **$521,100** |

Schedule 4

Calculations for a $5,000,000 net sale to an IDGT are as follows:

| | | |
|---|---|---|
| Annual Total Earnings of Corporation | $ 5,400,000 | |
| Annual Total Earnings of Trust | $ 1,263,600 | ($5,400,000 x 23.4%) |
| Annual Distribution of Earnings to Trust | $ 783,432 | ($1,263,600 x .62) |
| Total Trust Earnings Over Note Term | $11,372,400 | ($1,263,600 x 9) |
| Total Trust Distributed Earnings Over Note Term | $ 7,050,888 | ($ 783,432 x 9) |

Cash flow analysis of installment note payments and treatment:

Tax Calculation:

| | |
|---|---|
| Total Trust Income | $11,372,400 |
| Income Tax on S Corp Earnings @ 40% over trust term | $4548960 |