Estate Planning With Disregarded Entities

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Goal

- To Transfer Substantial Wealth
  - Wealth Transfer tax-free
  - Income tax-free

Modern Wealth Planning

- The interaction and blending of several important components:
  - Trusts
    - Dynastic
    - Income tax defective with respect to:
      - the grantor (IRC §§ 671-677); or
      - to the beneficiary (IRC § 678)
    - Split-interest trusts – GRATs

Modern Wealth Planning

- Leveraged strategies
- Pass-through entities to obtain valuation discounts
  - S-corporations
  - FLPs
  - FLLCs
- Sophisticated financial modeling

Enhancing the Wealth Shift by Adding the "Disregarded Entity" Component

- Entities which are disregarded for income tax purposes, but are recognized for state law and wealth transfer tax purposes
- The assets being transferred have low cash flow or cash flow insufficient to pay solely out of cash flow:
  - the GRAT annuity; or
  - the installment obligation
- The goal is to avoid "in-kind" payments to the grantor that will be subject to valuation discounts

Enhancing the Wealth Shift by Adding the "Disregarded Entity" Component

- The client would like to leverage the wealth shift, and
  - Maintain management and control
- The entity has low basis assets that we would like to use in the wealth shifting process, but which we would like to receive back so that they will receive a set-up in basis at death

Sample Client Profile

- $10 million real estate property
- Cash flow 5%, appreciation 5%
- Three children
- Desire to give 1/3 to each child
- Assume 40% valuation discount
- Assume
  - AFR 6%
  - Annual Midterm Rate 5%

Our Unique Problem

- Major assets have a low cash flow - 5%
- GRAT - Actual payment of the annual annuity must be made. Treas. Regs. §25.2702-3
- IDGT - Interest and balloon payment must be paid
- Desire to contribute *discountable* assets and receive back *non-discountable* assets

Concepts We Will Be Using

- Income Tax Defective Trust
  - Rev. Rul. 85-13
- Disregarded Entity
- The Estate Planner's Dream – "Passing on More Wealth Than Meets the Taxable Eye"

Planning
The Estate Planner's Dream

- Transfer discountable, income – producing property
- Receive back cash (or non-discountable assets)
  - *In effect, the discount is passed on tax-free to the donor*
- In a tax-free transfer

Disregarded Entity

- Single owner entity that has not elected to be classified as an association (corporation)
  - IRC §7701; Treas. Reg. §§301.7701-1(a) and 301.7701-2(c)(2)
- Entity existence is ignored
  - A "tax nothing"
- Concept similar to the "Defective Trust" concept

Disregarded Entity

- Rev. Rul. 2004-77
  - An eligible entity with two owners under local law can be treated as a disregarded entity
- Rev. Rul. 2004-88
- Other Examples
- *Pierre v. Comm'r*, 133 T.C. No. 2 (Aug. 24, 2009)

GRAT/DISREGARDED ENTITY COMBO

GRAT

- Gift to trust in exchange for an annuity substantially equal in value to transferred property
- Generally annuity increases by 20% a year

Low Cash Flow GRAT

For transfer tax purposes, no aggregation of transfers to separate trusts. *Rev. Rul. 93-12*

GRAT Illustration

Graduated 10-Year: 5% income, 5% growth

§7520 Rate:	6.00%
Income Earned by Trust:	5.00%
Term:	10
Annual Growth of Principal:	5.00%
Pre-discounted FMV:	$10,000,000
Discounted FMV:	$6,000,000
Percentage Payout:	5.69699%
Annual Annuity Payment Growth:	20.00%
Value of Grantor's Retained Interest:	$5,999,990.11
Taxable Gift:	$9.89

GRAT Illustration

Graduated 10-Year: 5% income, 5% growth

YEAR	BEGINNING PRINCIPAL	5.00% GROWTH	5.00% ANNUAL INCOME	ANNUAL PAYMENT	REMAINDER
1	$10,000,000.00	$500,000.00	$512,500.00	$341,819.40	$10,670,680.60
2	$10,670,680.60	$533,534.03	$546,872.38	$410,183.28	$11,340,903.73
3	$11,340,903.73	$567,045.19	$581,221.32	$492,219.94	$11,996,950.30
4	$11,996,950.30	$599,847.52	$614,843.70	$590,663.92	$12,620,977.60
5	$12,620,977.60	$631,048.88	$646,825.10	$708,796.71	$13,190,054.87
6	$13,190,054.87	$659,502.74	$675,990.31	$850,556.05	$13,674,991.87
7	$13,674,991.87	$683,749.59	$700,843.33	$1,020,667.26	$14,235,557.22
8	$14,038,917.53	$701,945.88	$719,494.52	$1,224,800.71	$14,415,452.38
9	$14,235,557.22	$711,777.86	$729,572.31	$1,469,760.85	$14,207,146.54
10	$14,207,146.54	$710,357.33	$728,116.26	$1,763,713.02	$13,881,907.11
SUMMARY	$10,000,000.00	$6,298,809.02	$6,456,279.23	$8,873,181.14	**$13,881,907.11**

Options to Pay Annuity

- **"In Kind" distributions of LLC interests**
  - **Grantor trust – no income tax on payments "in kind" of appreciated property**
  - **Discountable**
  - **Appraisal and valuation problems**
  - **Future growth back in estate**
    - ***Reduces wealth transfer***
    - ***Violates to goal of receiving assets back not subject to discounts***

Options to Pay Annuity
- cont. -

- Purchase the property from the LLC
  - LLC owns 100 % of property
  - Purchase is of 100% of property
  - No discount
  - Can be by note
    - *Potential cash flow issue*
    - *Can use GRAT annuity payments to alleviate cash flow problems*

How Does The "Disregarded Entity"/GRAT Income Tax Combo Work?

- **GRATs are grantor trusts.** IRC §§673(a),677(a)
- **Each GRAT is "owned" by the grantor for income tax purposes**
- **Entity with a single owner is disregarded.** IRC §7701

GRAT Illustration

Graduated 20-Year: 2%income, 6% growth

§7520 Rate:	**6.00%**
Income Earned by Trust:	**2.00%**
Term:	**20**
Annual Growth of Principal:	**6.00%**
Pre-discounted FMV:	**$10,000,000**
Discounted FMV:	**$6,000,000**
Percentage Payout:	**1.27810%**
Annual Annuity Payment Growth:	**20%**
Value of Grantor's Retained Interest:	**$5,999,996.99**
Taxable Gift:	**$3.01**

GRAT Illustration

Graduated 20-Year: 2% income, 6% growth

YEAR	BEGINNING PRINCIPAL	6.00% GROWTH	2.00% ANNUAL INCOME	ANNUAL PAYMENT	REMAINDER
1	$10,000,000.00	$600,000.00	$206,000.00	$76,686.00	$10,729,314.00
2	$10,729,314.00	$643,758.84	$221,023.87	$92,023.20	$11,502,073.51
3	$11,502,073.51	$690,124.41	$236,942.71	$110,427.84	$12,318,712.79
4	$12,318,712.79	$739,122.77	$253,765.48	$132,513.41	$13,179,087.63
5	$13,179,087.63	$790,745.26	$271,489.21	$159,016.09	$14,082,306.01
20	$25,897,090.02	$1,553,825.40	$533,480.05	$2,449,964.32	$25,534,431.15
SUMMARY	$10,000,000.00	$22,221,429.62	$7,629,357.47	$14,316,355.94	**$25,534,431.15**

Comparison of GRAT Results

- Level payment GRATs has insufficient cash flow beginning in year one (1)
    - Must make payments "in-kind"
- Increasing payment GRAT has insufficient cash flow beginning in year (5)
    - Must make payments "in-kind"
- GRAT with disregarded entities is able to make payments out of cash flow for every year, beginning in the first year

NOTE SALE TO IDGT/ DISREGARDED ENTITY COMBO

IDGT – NOTE SALE

- Non-controlling interests are sold to an income tax defective trust in exchange for an installment note, generally interest only with a balloon payment.

Low Cash Flow Note Sale

For transfer tax purposes, no aggregation of transfers to separate trusts. *Rev. Rul. 93-12*

Note Sale to IDGT with Low Cash Flow Asset

- Interest paid from
  - "Seed" money
  - Cash flow
- When "seed" money and cash flow insufficient – buy asset from entity

Alternatives to QPRTs

Qualified Personal Residence Trusts and Alternative Solutions

What is a QPRT?

- ❑ Grantor transfers residence to trust
- ❑ Grantor retains:
  - ❖ Right to use and occupy residence for specified term; and
  - ❖ Contingent reversionary interest

QPRT Disadvantages Which We Want to Eliminate or Reduce

- ❑ Large gift
- ❑ Mortality Risk
- ❑ Prohibition against reacquisition
  - ❖ To obtain step-up in basis at death
  - ❖ To live in residence
- ❑ Complex, rigid regulatory requirements

QPRT
Strict Regulatory Rules

- Reg. §25.2702-5(c) **contains a long list of requirements**
- **Reacquisition of residence prohibited either during or after the term**
  Reg. §25.2702-5(b)(9)

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QPRT v. GRAT

- **Unified credit used**
  - **QPRT substantial**
  - **GRAT insignificant**
- **Term – risk of estate tax inclusion**
  - **QPRT substantial**
  - **GRAT term can be condensed**
- **Right to reacquire property in GRAT**

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QPRT v. IDGT

- **Sale v. Gift**
- **Survivorship feature**
- **Right to reacquire property**
  - **To own**
  - **To obtain basis step-up**
- **Generation-skipping**

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Other Applications

- Double LLC Technique
- SCIN/ GRAT Technique
- Nevada Asset Protection Trust with Two (2) LLCs
- Beneficiary defective Inheritor's Trust ("BDIT")

