The Use of Pass-Through Entities in Asset Protection and Wealth Transfer Planning

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Judge Learned Hand, Federal Judge, said in 1934

"Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the treasury; there is not even a patriotic duty to increase one's taxes."

Asset Protection Planning

- Many transactions continue to carry liability post closing
  - Representations and warranties
  - Excluded liability provisions
  - Indemnities
  - Fiduciary after closing as officer
- Protect your finances and assets from creditors (including buyers)
- Reduce risk of being target of lawsuit
- Protection for assets and situations excluded by insurance coverage
- If you don’t own it, creditors cannot get it

Pass-Through Entities

- Business structures that avoid corporate double taxation and do not pay income taxes at the entity level.
- Income is allocated among owners, and income taxes are only levied at the owner level.
- Types:
  - Limited Partnerships
  - Limited Liability Companies
  - S-Corporations

Limited Partnerships

- Single-level of taxation under Subchapter K
- Two types of partners
  - General Partners
    - Managerial control
    - Personal liability
  - Limited Partners
    - No control
    - No personal liability
    - At risk only to extent of capital
- Moderately flexible structure and governance
  - Less risk of “piercing the corporate veil”

Limited Partnerships

- Avoids joint and several liability of general partnerships
- Subject to charging orders as main remedy of creditors
- Examples of Common Use:
  - Family Limited Partnerships
  - Real Estate Ventures

Limited Liability Companies

- Single-level of taxation under Subchapter K (Partnership) or Subchapter S (S Corporation)
- Greatest flexibility of structure and governance
  - Many options for agreement among members
  - Little to no risk of “piercing the corporate veil”
- Subject to charging orders as main remedy of creditors
- Examples of Common Use:
  - Operating Businesses
  - Family LLCs

S Corporations

- Single-level of taxation under Subchapter S (S Corporation)
- Least flexibility of structure and governance
  - Corporate formalities give rise to risk of “piercing the corporate veil”
  - Single-class of stock requirement limits options for agreements among owners (the class can have voting and non-voting)
- Subject to levy by creditors
- Commonly used for service-providing companies

Valuation Discounts

- Discounts for Lack of Control (Minority Interest)
- Discounts for Lack of Marketability
- Discounts for Built-in Gains Tax
- Proposed Regulations
  - If made final will prohibit discount for lack of control or lack of marketability in connection with the transfer of an interest in a family controlled entity, even if the entity operates a business
  - TRUMP STOPED ALL NEW REGULATIONS

Lifetime Gift of Business Interest

- Lifetime Gift of business interest
- $14,000 annual gift exclusion
- $5,490,000 lifetime gift exclusion
- Use Trust to maintain control
- Use Group Trust to leverage annual exemptions
- Use Discounts to leverage annual exemptions
- Use Grantor Trust for Income Tax purposes

Gift of Business Interest

Family Business, LLC

Client

100% Membership Interest

2016 Children's Trust

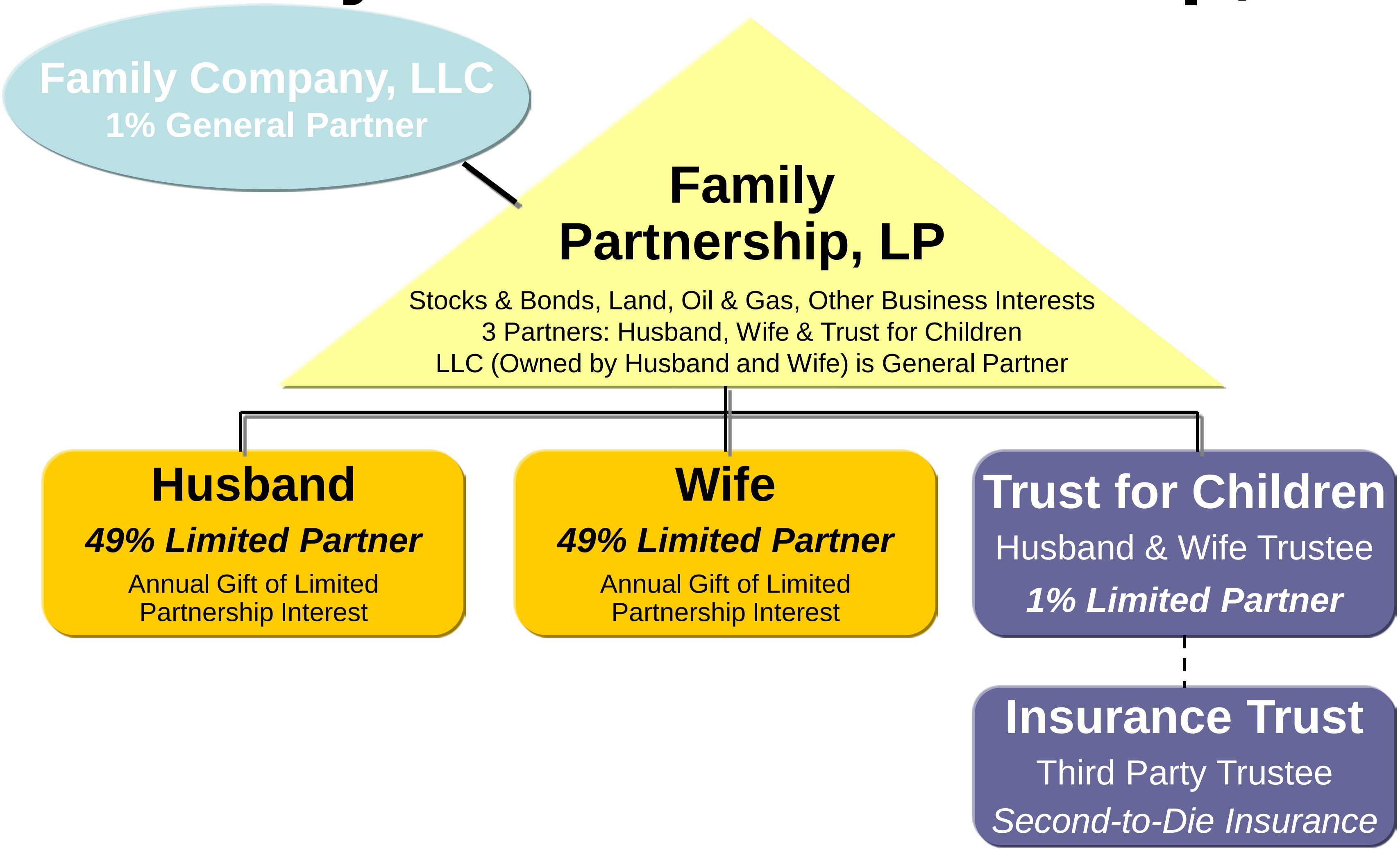
Client or 3rd party Trustee
Children & Grandchildren

Client gifts percentage of membership interest to the Trust, so that Trust becomes equity owner

Trust is a Grantor Trust so Client is treated as owner for income tax purposes

*May need to recapitalize to give away non-voting interest

Family Limited Partnership, LP



Installment Sale to Intentionally Defective Grantor Trust

Installment Sale to Grantor Trust

- Wealth transfer technique involving selling property to a trust established for benefit of client's heirs (i.e., children) in exchange for a promissory note at AFR
- Result is that the asset sold to the trust and any appreciation is removed from the client's taxable estate and replaced with a note receivable
- Can leverage gift/estate tax exemption through application of valuation discounts

Advantages of Installment Sale

Primary Advantages	Secondary Advantages

Primary Advantages

- Freezes growth of transferred assets in Grantor's estate
- No income tax consequences of sale or interest payments on note
- Trust assets grow free of income taxes
- Trust assets grow free of estate and GST taxes
- No gift consequences from Grantor's payment of Trust's income taxes
- Client/Grantor's estate reduced by income tax payments
- Distributions to Trust beneficiaries are income tax free

Secondary Advantages

- Trust may own "S" stock
- No transfer-for-value on transfer to Trust of policy insuring Grantor/Client

When to Consider Installment Sale

- Client/Grantor owns assets expected to increase in value
- Client/Grantor agreeable with transfer
- Client/Grantor comfortable with risk
- Cash flow exists or can be created to make Note payments
- Discounts apply in valuing asset being sold
  - Limited Partner Interest
  - Minority Stock
  - Non-voting Stock (can be created with recapitalization)

Important Considerations

- Be sure Coverage Exists
  - Insures bona fide sale
  - Seed Gift (10% rule of thumb)
  - Personal Guaranty
- Be sure Trust has zero inclusion ratio for GST purposes
- Strive to pay off note before death

Promissory Note Terms in Transaction

- Interest Rate
  - 1 – 3 year note: short-term AFR (1.15%)
  - 4 – 9 year note: mid-term AFR (2.04%)
  - Over 9 year note: long-term AFR (2.75%)
- Payment Options
  - Traditional Amortization
  - Balloon Note
  - Demand Note
  - Interest Only
- Prepayments allowed without penalty
- Payments In-Kind authorized
- Collateral: Asset being sold

Case Study

- Husband and Wife in their mid 60s
- 2 children
- Total Estate: $20M
- Net Asset Value of FLP: $12,885,424
- Discounted Sales Price: $7,200,000
  - Note, this client took on some gift tax risk
- Annual Return on Undiscounted Assets: 5%
- Terms of Note: 9 years; interest only at 1.65%; balloon payment
- Made $500,000 outright seed gift to trust

@ 5% GROWTH				
	Undiscounted Value of Trust at Beginning of Year	Income/Growth for Trust	Note Payment to Client	Undiscounted Value of Trust at End of Year
1	**$12,885,424**	$644,271.20	($118,800)	$13,410,895
2	$13,410,895	$670,544.76	($118,800)	$13,962,640
3	$13,962,640	$698,132.00	($118,800)	$14,541,972
4	$14,541,972	$727,098.60	($118,800)	$15,150,271
5	$15,150,271	$757,513.53	($118,800)	$15,788,984
6	$15,788,984	$789,449.20	($118,800)	$16,459,633
7	$16,459,633	$822,981.66	($118,800)	$17,163,815
8	$17,163,815	$858,190.75	($118,800)	$17,903,206
9	$17,903,206	$895,160.28	($118,800)	$18,679,566
10	$18,679,566	$933,978.30	($118,800)	$19,494,744
11	$19,494,744	$974,737.21	($118,800)	$20,350,681
12	$20,350,681	$1,017,534.07	($118,800)	$21,249,416
13	$21,249,416	$1,062,470.78	($118,800)	$22,193,086
14	$22,193,086	$1,109,654.32	($118,800)	$23,183,941
15	$23,183,941	$1,159,197.03	($118,800)	$24,224,338
16	$24,224,338	$1,211,216.89	($118,800)	$25,316,755
17	$25,316,755	$1,265,837.73	($118,800)	$26,463,792
18	$26,463,792	$1,323,189.62	($118,800)	$27,668,182
19	$27,668,182	$1,383,409.10	($118,800)	$28,932,791
20	$28,932,791	$1,446,639.55	($7,318,800)	**$23,060,631**
TOTAL		$19,751,206.58	($9,576,000)	

Installment Sale to 678 Trust

(The Beneficiary Grantor Trust)

What is a 678 Trust?

- Client/Beneficiary Controlled Trust
- Client’s parents create a trust for client
- Client is trustee and beneficiary along with Client's descendants
- Parents gift $5,000 to the trust
- Because the beneficiary had the limited right to withdraw the gift the trust is Grantor to the beneficiary (meaning the beneficiary is treated as the owner of the trust property for income tax purposes)
- Trust assets should not be included in beneficiary's estate
- Trust assets should not be subject to the claims of beneficiary’s creditors
- Client/beneficiary has broad testamentary power to will away trust property
- Because client has testamentary power of appointment, any gifts to the trust as a result of the IRS asserting that the sale price is insufficient would result in an incomplete gift, not subject to immediate gift taxes.

Case Study

- Construction Company
- Client owned 38%
- Parent created 678 Trust for Client
- Client was trustee and beneficiary of the 678 Trust
- Parent gifted less than $5,000 to trust
- Client sold 38% to his 678 Trust for $753,000 in 2012 (price based on recent sale with exiting partner and book value)
- Terms of Note: 9-year at 0.89% interest; interest only payments
- Guarantee of 0.5% (best if have guarantee of someone other than seller)

Case Study – cont'd

- Company sold in 2015 for $72,000,000
- Client's 678 Trust received $29,500,000
- Client paid off promissory note ($753,000)
- Client now has roughly $22,000,000 (after taxes and note payoff) in a trust in which he is the trustee and beneficiary
- Assets should not be subject to estate taxes at his death
- Assets should not be subject to client's creditors
- Trust assets are generation skipping

Grantor Retained Annuity Trust (GRAT)

- An irrevocable Trust
- Grantor contributes property to trust
- Grantor retains right to receive an annuity payment
- The annuity is received for fixed number of years (or life if shorter)

GRAT and Transfer Taxes

- Fund with assets that are going to increase in value
- The actuarial value of the remainder portion of the asset transferred is a gift for gift tax purposes
- Annuity can be set high enough so that remainder is zero, so no gift would result
- If client/grantor dies during term of GRAT, property is included in client/grantor's estate
- If client/grantor survives the term, trust assets (including all appreciation) are transferred to named beneficiaries (e.g. trust for children), with no gift or estate tax
- The GRAT is a grantor trust for income tax purposes, meaning that the grantor pays the tax on all income realized by the trust, and that the grantor's receipt of the annuity is a non-taxable event

GRATs – Pros and Cons

Advantages	Disadvantages
■ Give away property while retaining an interest in the property for a period of years ■ Transfer the upside potential above the 7520 rate with no gift tax consequences ■ Assets transferred and all appreciation not subject to estate tax	■ Risk of death during term of GRAT. ■ No allocation of GST exemption until GRAT term expires ■ No annual exclusions available ■ Loss of step-up in basis

Popular in Low Interest Rate Environment

- GRATs more attractive in low interest rate environment because as 7520 rate increases the actuarial value of the retained interest decreases and the actuarial value of the remainder interest increases.

GRAT Example

At the end of the trust term, any assets left in the trust pass to the remainder beneficiaries designated in the trust agreement.

GRAT Example – 2-year zeroed out GRAT; 5% Principal Growth

- 7520 Rate (1.8%)
- Annual Growth of Principal (5%)

At the end of the trust term, remaining assets pass to the remainder beneficiaries designated by the trust agreement.

Key Formula
FMV of Property Transferred – PV of Retained Interest = Value of Gift
$1,000,000 - $1,000,000 = $0.00

GRAT Example – 2-year zeroed out GRAT; 30% Principal Growth

- 7520 Rate (1.8%)
- Annual Growth of Principal (30%)

At the end of the trust term, remaining assets pass to the remainder beneficiaries designated by the trust agreement.

Key Formula

FMV of Property Transferred – PV of Retained Interest = Value of Gift

$1,000,000 - $1,000,000 = $0.00

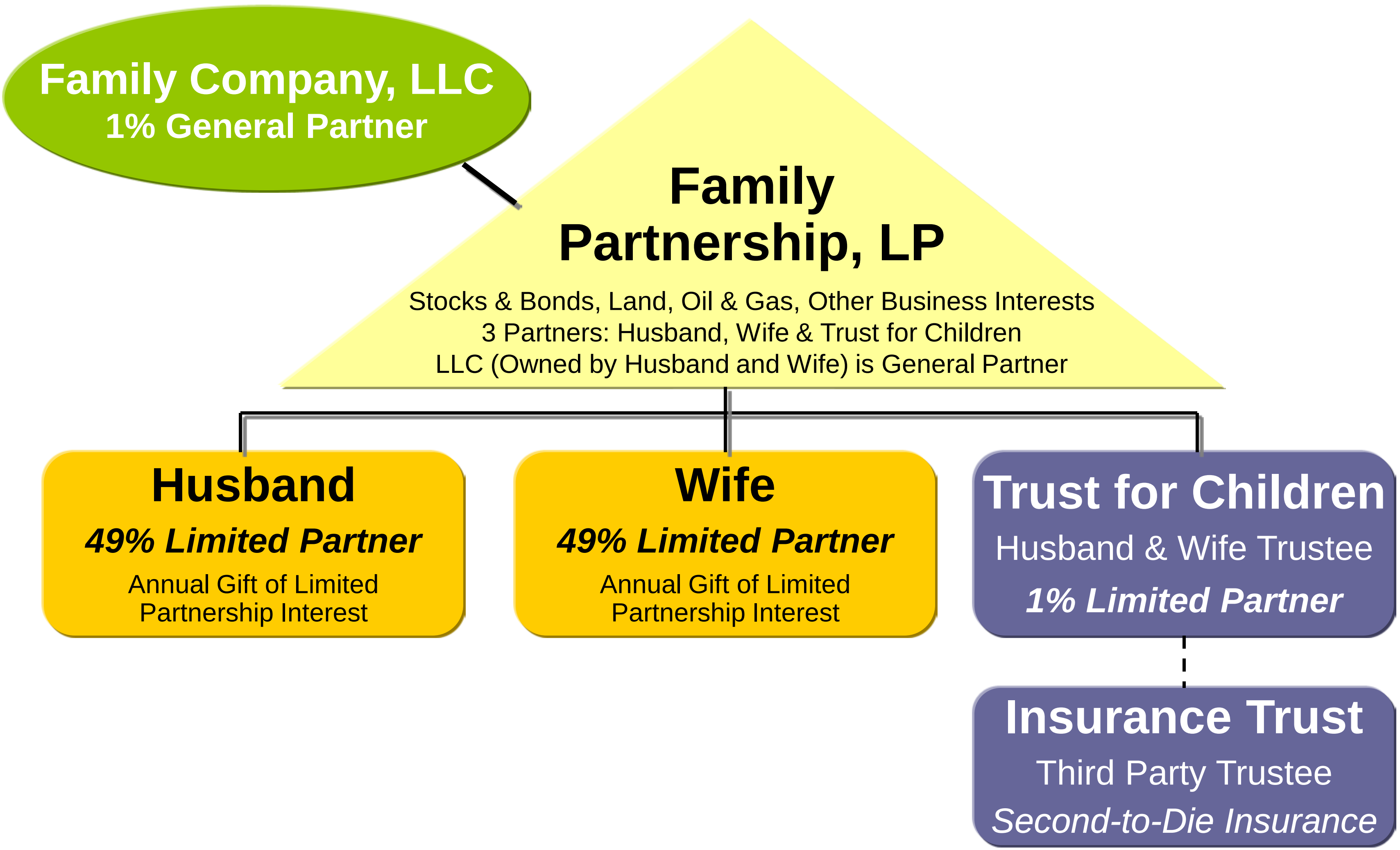
Rolling GRATs

- A series of short-term GRATs strung together to increase efficiency and reduce risk.
- Grantor uses a 2-year GRAT, and then reinvests the payments received from the GRAT into a new 2-year GRAT until the original trust term has been reached.

Comparing GRAT with IDGT

	SALE TO IDGT	GRAT
Discount rate for Payments to Grantor	Applicable Federal Rate	Section 7520 Rate (120% of mid-term AFR)
Reducing Gift to Zero	Yes, if price equals FMV	Can use a zeroed out GRAT
Grantor's Estate Inclusion	No inclusion	Included if Grantor dies during term of GRAT
Use of GST Exemption	Not required except for funding initial gift	Cannot allocate GST exemption until GRAT termination
Postponement of payments to Grantor	Can provide for interest only payments	Restricted, annual payment cannot exceed 120% of prior year's payment
Distribution Options	After note payments can spray among trust beneficiaries	Can distribute only to Grantor during term of GRAT

Family Limited Partnership, LP



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