Introduction

We consider 2012 historic in many ways. While the world did not end as the Mayan calendar predicted, there was fear that the world of wealth transfer opportunity could be ending. The $5.12 million lifetime exemption from the federal gift tax and federal estate tax was scheduled to default to $1 million and the lifetime federal generation skipping transfer (GST) tax exemption was set to decline to approximately $1.4 million at the close of 2012. Under the sunset provisions of The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, these exemptions would have resumed again in 2013. These were the exemption levels in effect prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

Further, without action by Congress, the top tax rate on these three taxes, encompassing taxable gifts, generation skipping transfers, and assets remaining in one’s taxable estate at death, was to increase from 35% to 55% (or 60% in some cases). Similarly, these pre-EGTRRA rates would have taken effect again in 2013. As a result, many individuals and their advisors scrambled to make gifts to utilize these higher gift tax and GST tax exemptions prior to year end.

On January 1, 2013, just hours after the reduced exemptions and rate increases took effect in the federal transfer tax system (collectively, the federal gift tax, GST tax, and estate tax are known as the federal transfer taxes because they tax transfers of wealth), Congress passed legislation to avoid falling off the Fiscal Cliff: the American Taxpayer Relief Act of 2012 (ATRA). Signed the following day by President Obama, ATRA (Public Law 112-240, H.R. 8, 126 Stat. 2313) was passed to modify the default transfer tax regime and was effective immediately.

Under ATRA, the base lifetime exemption for all three transfer taxes is $5 million, indexed annually for inflation (for 2013, the adjusted exemption is $5.25 million). Also, the top rate was adjusted from 35% to 40%.

Many affluent families had already made gifts to take advantage of all or most of their $5.12 million ($5 million base exemption in 2011, indexed for inflation) gift tax or GST tax exemptions, or both, in 2012. In many cases, such transfers were made to family trusts.
In the first-quarter 2012 Hawthorn white paper, *The 2012 Family Opportunity Trust*, we discussed a Family Opportunity Trust as an ideal vehicle for family wealth transfer. For those who took advantage of such a trust or for those who might consider such a trust, the opportunities are significant, we believe, for dramatically leveraging and amplifying the wealth transfer opportunity provided by the higher gift tax and GST tax exemptions, along with the annual inflation indexing. This paper will review the essentials of a Family Opportunity Trust and the means by which gifts made in 2012 or thereafter can be enhanced for the benefit of family wealth preservation and growth on a multigenerational basis.

**The Family Opportunity Trust Revisited**

A Family Opportunity Trust contains four key elements, as outlined below.

1. **The Trust Is Irrevocable**

   The trust is irrevocable so that the assets can be excluded from the grantor's taxable estate pursuant to Section 2038 of the Internal Revenue Code of 1986, as amended (hereafter IRC). Gifts by the grantor to such a trust not exceeding his or her federal gift tax exemption (currently $5.25 million, indexed for inflation) will not create gift tax liability, and those assets and their growth will be outside the grantor's taxable estate at his or her death. The grantor's spouse can join in the gifts either by transferring assets directly or by consenting to a gift-splitting election to have the gifts made by the grantor deemed to have been made one-half by the grantor and one-half by the grantor's spouse, thereby doubling the potential transfer tax-free gifting to $10.5 million in 2013 (IRC Section 2513).

   Further, because the grantor's federal gift tax exemption is indexed for inflation each year, he or she can transfer that additional amount to the trust with the same benefit, as can the grantor's spouse. In addition, the grantor (and his or her spouse with the spouse's own assets or by the spouse's consent to the grantor's gifts) can potentially transfer additional amounts equal to the annual gift tax exclusion, which is currently $14,000\(^1\) ($28,000 for a married couple, through direct gifts by each spouse or by gift-splitting under IRC Section 2513) per beneficiary of the trust, if the beneficiary is provided the right to withdraw the gifted amount for a brief period of at least 30 days following the transfer to the trust.\(^2\)

   Making such annual gift tax exclusion transfers to a Family Opportunity Trust, however, is typically not practical because a corresponding GST tax annual exclusion is only available for transfers outright to a grandchild or other "skip person" (which includes descendants two or more generations removed from the transferor, such as grandchildren and more remote descendants, or unrelated beneficiaries more than 37 1/2 years younger than the transferor), or to specific trusts that are limited to one skip person beneficiary and which will vest in that beneficiary during his or her lifetime or be included in his or her taxable estate at death (IRC Section 2642(c)(2)). With this GST tax annual exclusion not

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1 IRC Section 2503(a) and (b); Revenue Procedure 2012-41. IRC Section 2503(b) provides for an inflation adjustment of the annual gift tax exclusion in any year when the adjustment reaches an increment of $1,000 (rounded down), resulting in the increase from $13,000 to $14,000 in 2013.

2 Revenue Ruling 81-7, 1981 C.B. 474 (1981); Private Letter Rulings 9311020 and 9232013 (1992). This limited right of withdrawal is typically known as a Crummey power, named after Crummey v. Commissioner, 397 F.2d 82 (9th Circuit 1968), the court ruling that first approved of this approach.
available for a multibeneficiary, multigenerational Family Opportunity Trust, and lifetime GST tax exemption presumably applied in unison with the lifetime gift tax exemption for such transfers, additional annual exclusion gifts beyond these lifetime exemption transfers are typically best directed toward other gifting. Such alternative uses of the annual gift tax and annual GST tax exclusions could include, for example, outright gifts, contributions to Section 529 Education Plans for descendants, or trusts for individual grandchildren satisfying the provisions of IRC Section 2642(c)(2).

Although the trust must be irrevocable and generally inaccessible to the grantor going forward (IRC Section 2036(a)(1)), a married grantor could include his or her spouse as a beneficiary, in addition to their descendants. By doing so, the grantor could provide for indirect access to the trust assets for the balance of the spouse’s lifetime while excluding the assets from the taxable estates of both the grantor and the grantor’s spouse. This type of trust is often referred to as a Spousal Lifetime Access Trust (SLAT). Access for the spouse must typically be limited to an ascertainable standard in order to exclude the assets from his or her taxable estate, which can include broad criteria such as his or her health, maintenance, support, and education (IRC Section 2041(b)(1)(A)). Alternatively, an independent trustee could potentially exercise discretion to make distributions to the grantor’s spouse for purposes broader than the already broad standard of health, support, maintenance, and education. Should the grantor’s spouse predecease the grantor, however, the grantor would be cut off from further indirect benefits from the trust.

One disadvantage of having the grantor’s spouse as a beneficiary of a Family Opportunity Trust is that gift-splitting is generally not available. The grantor’s spouse would have to make his or her own gift of assets to utilize his or her exemption. This would generally prevent the spouse from having any beneficial interest in the trust in order to prevent inclusion of the assets in his or her estate.

Alternatively, it is possible for each spouse to separately establish a Family Opportunity Trust as the grantor, transfer assets utilizing his or her gift tax exemption (and GST tax exemption), and name the other spouse as a beneficiary along with their descendants. Under such an approach, it is important that the couple’s attorney craft the trusts with sufficient differences to prevent the trusts from being considered “reciprocal.” If a trust is considered reciprocal, it could cause the Internal Revenue Service (IRS) to disregard the trusts for estate tax purposes and correspondingly include the assets of the trusts in the couple’s taxable estates.

2. The Trust Is Perpetual
The trust is perpetual such that by applying the grantor’s federal GST tax exemption to the transferred assets, the trust assets and their growth can be excluded from the taxable estates of the beneficiaries (for example, children,

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1Treasury Regulation Section 25.2513-1(b)(4). Under this regulation, however, if the spouse’s beneficial interest is limited to an income interest, gift-splitting may be allowed after subtracting the actuarial value of this income interest.

2There is the alternative possibility of utilizing a Delaware Asset Protection Trust as a means of allowing the grantor to retain a beneficial interest in a Family Opportunity Trust.

grandchildren, and subsequent generations). A majority of states now permit perpetual trusts. Accordingly, under current federal tax law and most states’ laws, by applying GST tax exemption to gifts made to a trust, the trust assets and their appreciation can be excluded from the beneficiaries’ taxable estates for a potentially infinite number of generations. Also, the grantor’s spouse can apply his or her GST tax exemption to gifts he or she makes to the trust, or consents to through gift-splitting (IRC Section 2652(a)(2)), to potentially double the assets that can be transferred and exempted from multiple generations of beneficiaries’ taxable estates.

The GST tax is intended to prevent the avoidance of federal estate tax or gift tax in future generations through the creation of long-term trusts for grandchildren or more remote descendants. These long-term trusts may benefit children but ultimately benefit subsequent generations of beneficiaries. Direct transfers or transfers in trust (or from a trust) to or for skip persons (IRC Section 2631(a)) can trigger the GST tax (IRC Section 2612), which applies in addition to any applicable federal gift tax or estate tax and at the same top rate (IRC Section 2602).

As a hypothetical example, if a grantor has used all of his lifetime gift tax and GST tax exemptions and then makes a $1 million gift to his grandchildren (or in trust for them), the grantor would be liable for both a 40% federal gift tax and a 40% GST tax, resulting in total transfer tax liability of $800,000.

The GST tax could also apply to a trust at a future point when all nonskip persons (IRC Section 2631(b)), such as children, have died (IRC Section 2612(a)).

By applying available federal gift tax exemption and GST tax exemption to all gift transfers to a multigenerational Family Opportunity Trust, no federal transfer tax will be applicable to the trust assets, the growth of those assets, or distributions from the trust (IRC Section 2642(a)). Accordingly, establishing such a trust in a state allowing for its perpetual existence can provide a powerful tool for long-term wealth transfer and growth, as illustrated in Chart 1, demonstrating the difference in growth of a multigenerational trust’s assets, even at a modest 3% net rate of return, if federal estate taxation is avoided in each generation.

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![Chart 1](image)

**Chart 1**

*Growth Advantage of Assets in Family Opportunity Trust*

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1 By ensuring that GST tax exemption is allocated to all assets gifted to the trust, its inclusion ratio will be zero, ensuring that the trust will be entirely exempt from GST tax. Allocation of GST tax exemption is governed by IRC Section 2631.
3. The Trust Is a Grantor Trust

The trust is a grantor trust for income tax purposes. Although the trust is considered owned by the grantor for income tax purposes, and therefore all tax items (for example, income, capital gain, and dividends) are taxed to the grantor on his or her personal tax return, the trust is “defective” in that it is not considered owned by the grantor for federal estate tax purposes. Often, this type of trust is known as an Intentionally Defective Grantor Trust (IDGT) because the grantor intentionally structures the trust with a specific reserved power or powers such that it is a grantor trust for income tax purposes (although irrevocable and excluded from his or her taxable estate for federal estate tax purposes) to obtain the wealth transfer benefits of such a design. For purposes of this paper, we refer interchangeably to an IDGT, and the additional features suggested, as a Family Opportunity Trust.

Utilizing an IDGT structure allows the trust assets to grow unencumbered by federal income taxation. Further, trusts are taxed at the maximum 39.6% rate upon reaching $11,950 of taxable income (IRC Section 1(e)), whereas individuals reach that level at the much higher levels of $400,000 (single) or $450,000 (married filing jointly) (IRC Section 1(a) and (c)).

A nongrantor trust could instead distribute its taxable income to the beneficiaries, thereby shifting responsibility for the tax liability thereon to them, possibly at a lower tax rate. Nevertheless, the after-tax amount available to the beneficiaries of a nongrantor trust would be reduced by income taxes regardless of whether the trust accumulated or distributed taxable income.

On the other hand, a grantor trust, by shifting tax liability for the taxable income of the trust to the grantor, eliminates income tax leakage from the trust on income and capital gains, thereby allowing the trust to grow to its fullest potential for its beneficiaries and maximizing the wealth transfer objective of the trust. The IRS has ruled (Revenue Ruling 2004-64, 2004-27 I.R.B.) that the grantor’s payment of income tax liability respecting income and gains of the trust is not an additional gift to the trust and does not require the grantor to use gift tax exemptions or exclusions or pay gift tax.

In that same ruling, the IRS stated that the trust could allow the trustee, in its discretion, to reimburse the grantor for some or all of the income tax liability paid on behalf of the trust. We believe such a provision provides flexibility should the grantor’s financial situation change or should there be extraordinary taxable income or capital gains in the trust in a given year or years.

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1 There are various powers that can be reserved by a grantor in a trust which can cause the trust to be a grantor trust (owned) for income tax purposes, but nevertheless not considered owned or includible in the grantor’s taxable estate for federal estate tax purposes (that is, defective). Perhaps the most commonly utilized power to create this effect is the power reserved to the grantor in a nonfiduciary capacity to substitute assets of equal value in exchange for existing trust assets (a swap power) under IRC Section 6751(4)(C), which carries the additional benefit of creating planning opportunities as discussed further herein. Under IRC Section 2036(a), however, allowing for exchanges that are bona fide exchanges or sales for adequate and full consideration in money or money’s worth will not cause inclusion of the trust assets in the grantor’s taxable estate for estate tax purposes. This principle was expressly confirmed in Revenue Ruling 2008-22, I.R.B. 2008-16 (2008).

2 With the exception of capital gains under most circumstances, distributions to beneficiaries of a nongrantor trust generally carry out distributable net income (DNI) to the extent of taxable income in the trust, causing such income to be taxable to the beneficiary at his or her individual rates with a corresponding deduction to the trust. IRC Sections 643(a)(1) and (3) and 661.
One concern, however, is that Revenue Ruling 2004-64 also held that if either the trust document or state law required (rather than permitted in the trustee’s discretion) that the grantor be reimbursed for tax paid on behalf of the trust, then this would constitute the right to have trust property used to discharge a legal obligation of the grantor, causing inclusion of the trust assets in his or her taxable estate (this aspect of the ruling was based on IRC Section 2036(a)(1)). While a trust can readily be drafted to permit but not require the trust to reimburse the grantor for taxes paid with respect to the trust to steer clear of this aspect of the ruling, the provisions of state law on this issue cannot be controlled. There is a question as to whether the law of some states, Pennsylvania, for example, requires a trust to reimburse the grantor for taxes he or she pays on behalf of the trust. This concern provides an additional rationale for utilizing Delaware law and situs for a Family Opportunity Trust (Delaware state law does not require reimbursement of a grantor for taxes paid with respect to a trust’s income). Additional reasons for using Delaware situs for a Family Opportunity Trust are discussed below.

In addition, any transactions between the grantor and such a trust will have no effect for income tax purposes because any such transfers are considered made by the grantor to himself or herself (Revenue Ruling 85-13, 1985-1 C.B. 184 (1985)). This income-tax-neutral nature of a defective grantor trust creates many possibilities for leveraging a Family Opportunity Trust.

4. The Trust Has Delaware Situs

In addition to allowing for a trust’s perpetual existence, Delaware trust law provides additional asset protection, flexibility, ease of administration, and an accessible court system that provides advantages over many other states. (For more information, see the first-quarter 2012 Hawthorn white paper, The 2012 Family Opportunity Trust.)

Along these lines, one significant potential benefit is the possibility of structuring a Delaware situs Family Opportunity Trust such that the grantor could receive distributions, in the sole discretion of an independent trustee, while nevertheless excluding the trust assets from his or her taxable estate (12 Delaware Code Section 3570(8)(a)). A handful of states, Delaware being the first, allow a grantor to establish an asset protection trust with a spendthrift provision that prevents creditors of the grantor from reaching the assets. As a result, the Internal Revenue Code would treat the grantor’s transfer of assets to such a trust as a completed gift for transfer tax purposes and outside his or her taxable estate, even

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1 See French Trust, 23 Fiduciary Reporter 296 (Philadelphia County Orphans Court 1963) and Mathay Trust, 1 Fiduciary Reporter 2d 96 (Montgomery County Orphans Court 1981) regarding Pennsylvania law on this issue.

2 Delaware Code, Section 503. Under Delaware law, a trust may have perpetual existence. A 110-year limitation period does, however, remain for real estate held in trust. 25 Delaware Code Section 503(b). By holding real estate in an entity such as a Limited Liability Company or Limited Partnership, however, and transferring interests in that entity to a Delaware trust, the 110-year limitation period is inapplicable. 25 Delaware Code Section 503(e).

3 Delaware situs trusts require that at least one trustee must be either a resident of Delaware or an entity that is authorized by Delaware law to act as a trustee in that state. 12 Delaware Code Section 3570(8)(a). Accordingly, references herein to the independent trustee of a Family Opportunity Trust means a Delaware corporate fiduciary.

4 Note that all states allow a trust to provide spendthrift creditor protection provisions with respect to beneficiaries who are not the grantor of the trust.
though an independent trustee could make discretionary distributions back to the grantor. This approach helps overcome understandable reluctance on the part of a grantor concerned that some portion (or all) of the assets transferred to the Family Opportunity Trust might be needed for emergencies or other unforeseen financial circumstances.

Depending upon the grantor’s state of residence (and in some cases, the beneficiaries’ state of residence), and assuming the trust beneficiaries do not reside in Delaware, establishing a Family Opportunity Trust with Delaware situs may allow for avoidance of state income tax on the trust’s accumulated income. Some states, such as Pennsylvania, will tax a trust’s accumulated income, regardless of situs, if the grantor was a Pennsylvania resident at the time of the trust’s creation. Other states, such as New York and New Jersey, will not tax accumulated income of a Delaware situs trust if there are no in-state co-trustees or in-state source income.

Keep in mind, however, that such benefit will not typically apply for a Family Opportunity Trust until the grantor dies and grantor trust status for income tax purposes terminates. Until that time, most states treat grantor trusts for federal income tax purposes as grantor trusts for state income tax purposes and would therefore tax the income of the trust to the grantor (during this period, the trust nevertheless avoids diminution for state income tax because, like the federal income tax, it is paid by the grantor).

Leveraging the Family Opportunity Trust

In 2012, many individuals and families took advantage of their federal gift tax and GST tax exemptions, which they feared were going to default to much lower levels this year, by gifting assets to trusts with the key characteristics of Family Opportunity Trusts discussed above. (Hereafter, any reference to a Family Opportunity Trust is presumed to contain the four key characteristics noted earlier.) In many cases, such trusts and the corresponding gifts were completed near the end of 2012. In those situations, the best that could often be accomplished was the creation of the trust and a gift of relatively straightforward assets such as cash or marketable securities.

Still others who “missed the boat,” a boat that fortunately waited for them (that is, because the $5 million base exemption for the three federal transfer taxes, indexed for inflation, remains in effect) can now establish a Family Opportunity Trust to effectively utilize their exemptions.

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13 A grantor’s creditor’s access to trust assets can cause inclusion of the assets in the grantor’s estate under either IRC Section 2036(a)(2) (retained right to designate who will possess or enjoy the property) or IRC Section 2038 (retained right to alter, amend, or revoke the trust, such as by termination of the trust through a creditor’s attachment of all the assets). See Revenue Ruling 76-103, 1976-1 C.B. 293 (1976); Estate of Paxton v. Commissioner, 68 T.C. 785 (U.S. Tax Court 1986). By preventing creditor access to the grantor’s assets through the allowable grantor spendthrift clause under Delaware law, this obstacle to the grantor’s retention of a beneficial interest in the discretion of an independent trustee is removed. For more information, see the October 2012 Hawthorn white paper, 2012 Wealth Transfer—Flexible Options for Getting off the Fence, pp. 4–6.

14 Using the advantages of a Delaware Asset Protection Trust’s spendthrift clause as part of the Family Opportunity Trust structure provides the flexibility of potential grantor access to the assets through an independent trustee’s exercise of discretion to distribute to the grantor; nevertheless, such distributions should be viewed as an emergency fund of last resort and such should be borne in mind by the grantor when committing assets to a Family Opportunity Trust.


16 Some states, such as Florida and Texas, have no state income tax, so grantor trust status would not result in state income taxation of the trust’s income.
Individuals and their advisors can now reflect on what may be possible for further leveraging the benefit of the transfer tax exemptions with this type of trust. We believe the primary means of doing so are the grantor’s “swap” of higher potential growth assets for the existing cash or marketable securities held in the trust, the sale of additional assets to the trust, or both.

**Asset Swaps**

With IDGTs such as Family Opportunity Trusts, transfers of assets between trust and grantor are not subject to recognition of gain or loss, or to other income tax consequences. No gain is recognized, and the basis of the assets is not adjusted.

To allow for asset swaps (and in order to make a trust considered an IDGT, that is, a grantor trust for federal income tax purposes but not for federal estate tax purposes as noted above), such a trust typically includes a provision allowing for the grantor’s substitution of assets of equal value (that is, swapping). Even though no gain or loss is recognized on equal exchanges of assets between grantor and trust, one must be careful that any such swaps are, in fact, of equal value in order to ensure that the safe harbor for equal-value swaps is satisfied. Failure to do so can cause inclusion of the trust assets in the grantor’s taxable estate (IRC Section 2036(a)).

In addition to swapping high-growth potential assets for more conservative cash or marketable securities in the trust, a grantor might also take advantage of valuation-discounted assets in a swap with his or her Family Opportunity Trust. By so doing, further leverage could be attained.

Consider the following hypothetical example. Assume grantor created a Family Opportunity Trust in 2012 and gifted $10 million of blue chip stock with a tax cost basis of $2 million. Assume that grantor’s spouse made a consent election to use $5 million of her available $5.12 million gift tax exemption, thus resulting in the grantor and grantor’s spouse each making $5 million gifts to the trust, within their available $5.12 million exemptions. The grantor and his spouse also apply $5 million of their available $5.12 million GST tax exemptions to the transfer, thus creating GST tax-exempt status for the trust. Although the same assets can be exempt from both federal gift tax and GST tax, allowing for exemption of the trust assets from the taxable estates of the grantor and his or her spouse, children, and subsequent generations, a separate allocation of both the gift tax and GST tax exemptions is necessary to accomplish this objective.

In 2013, grantor meets with his attorney and creates a single member Limited Liability Company (LLC), contributing $150,000 cash to the LLC in exchange for all of the membership interests. The grantor then forms a Family Limited Partnership (FLP), contributing $14.85 million of commercial real estate properties in exchange for the 99% limited partnership interests. The LLC contributes its $150,000 cash in exchange for the 1% general partnership interest.

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\[17\] Revenue Ruling 2008-22, I.R.B. 2008-16 (2008) ruled that a power reserved by the grantor in a nonfiduciary capacity to reacquire trust assets by substituting assets of equivalent value under IRC Section 675(4)(C) does not cause inclusion of the trust assets in the grantor’s taxable estate under IRC Sections 2036 (power to enjoy or control enjoyment of trust assets) or 2038 (power to revoke trust).

\[18\] The 2010 Tax Act, which originally instituted the $5 million base exemption, (indexed for inflation) for the three transfer taxes, was extended as to this provision by ATRA. The inflation-indexed exemption amount was $5.12 million for 2012.
interest in the FLP. Utilizing an LLC as owner of the general partnership interest allows for insulation of individuals, such as the grantor in this example, from liability to which that interest may be subject.

The grantor then “swaps” his 99% limited partnership interests in the FLP with the Family Opportunity Trust in exchange for the $10 million of marketable securities therein, taking a 32.66% valuation discount for lack of marketability and control with respect to those limited partnership interests, making the exchange an equal trade ($10 million of limited partnership interests, as discounted, for $10 million of stock). This example is illustrated in Chart 2.

Chart 2
Asset Swap Illustration

No gain or loss is recognized for federal tax purposes by the grantor or the trust in this exchange, even though both assets have built-in capital gain in excess of their tax cost basis, because transactions between a grantor and a grantor trust are ignored for federal income tax purposes. (Some states do not recognize grantor trust status for state income tax purposes; Pennsylvania, for example, does not provide for grantor trust status such that Pennsylvania income tax would be recognized and payable on transfers between the grantor and his or her Family Opportunity Trust.) Rather, the tax cost basis of the assets carries over to the transferee. In addition, even though the underlying assets in the FLP are of significantly greater value than the discounted value of the FLP interests, it is the discounted value, taking into account the restrictions in the FLP agreement (that is, restrictions that limit the limited partners’ ability to sell or liquidate its interests, compel distributions or exert any other control over the

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19 Valuation discounts should only be taken with the guidance of tax and legal professionals, backed by a professional valuation report.

20 A limited partnership agreement, especially a family limited partnership agreement, generally provides substantial restrictions on the limited partners’ ability to sell or liquidate the interest, or to compel distributions or exercise other control over the partnership, making the interest worth less than the proportionate share of the underlying assets were they owned directly.
partnership), that controls in determining the appropriate equal swap value for the assets in the trust.  

Assume the underlying real estate in the LLC, with a true value of $14.85 million (as compared with the marketable securities originally in the trust worth just $10 million), appreciates 10% annually, and that the stock it is exchanged for enjoys a 6% annual return. The future value of the trust, either with or without the swap, is illustrated in Chart 3.

**Chart 3**

**Growth of Family Limited Partnership**

![Growth of Family Limited Partnership](chart.png)

*Source: Hawthorn/Babitz/Petrunia Information Services, Inc.*

as noted above. By taking advantage of the income tax neutral aspect of transactions between grantors and grantor trusts, and using assets gifted to a Family Opportunity Trust as collateral, the trust could purchase additional assets from the grantor. If the assets sold to the trust are (i) highly appreciating, (ii) possibly discounted in value (for example, limited partnership interests in an FLP), and (iii) the consideration provided by the trust to purchase those assets is a promissory note utilizing the current ultra-low interest rates available for intra-family loans, the wealth transfer results could be quite favorable.

An exchange between a grantor and grantor trust is not recognized for federal income tax purposes. Accordingly, such a trust’s exchange of a promissory note for assets from the grantor would not be recognized as a taxable exchange. The IRS has specifically ruled that a grantor’s sale of appreciated assets (that is, value exceeds tax cost basis) to a grantor trust in exchange for the trust’s

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21 Valuation of the proper discount for the restrictions attributable to limited partnership interests, as well as the value of sometimes difficult-to-value underlying assets in the partnership, is an inexact, subjective science subject to dispute by the IRS, even with the assistance of the best valuation, legal and tax advisors. Accordingly, the use of formula valuation clauses to provide that any excess value attributable to such interests, after settlement or adjudication with the IRS, instead pass to charity or other recipients not subject to gift taxation, can be effective in mitigating the risk of undesired and unintended transfer tax liability by eliminating both the unintended transfer tax liability as well as the IRS’s incentive to challenge the initial valuation. Although a full analysis of the subject of formula value clauses, and the two general types (formula transfer clauses and formula allocation clauses) is outside the scope of this paper, see additional discussion of this issue at note 33 in the Greater Valuation Risk subsection of the Comparison with GRATs section of this white paper.
promissory note will not cause the recognition of taxable capital gain (Private Letter Rulings 9535026 and 200434012).

The IRS has also ruled that loans between a grantor and grantor trust do not trigger taxable interest income because, for tax purposes, the grantor is deemed to have made a loan to himself or herself (Technical Advice Memorandum 9604005). Accordingly, not only will no gain recognition result from the sale of assets by a grantor to his or her grantor trust, but interest payments made by the trust to the grantor with respect to a promissory note given in exchange for the assets will also not be considered federal taxable income to the grantor.

**Wealth Transfer Objective**

A primary wealth transfer objective in a grantor’s sale of assets to his or her grantor trust is that the assets sold to the trust grow at a greater rate than the payments of principal and interest on the promissory note received by the grantor in exchange for the assets. Thus, the interest rate on the promissory note acts as a hurdle rate. To the extent the growth of the assets transferred to the trust exceed this rate, wealth is effectively transferred to the Family Opportunity Trust without use of transfer tax exemptions or payment of gift tax. The Internal Revenue Code governs the minimum interest rate that must be charged for intra-family loans (the interest rate on a promissory note issued to a grantor by a grantor trust, whose beneficiaries are family members of the grantor, would be subject to these provisions) to avoid imputation of interest and corresponding adverse tax consequences (IRC Section 7872 (a) and (f)). Fortunately, in the current low interest rate environment, these required interest rates are quite attractive. For June 2013, a promissory note with a term of three years or less (short-term) would require interest at a minimum rate of 0.18%, a loan of greater than three years but not more than nine years (midterm) would require interest at 0.95%, and a loan for a term of more than nine years (long-term) would require a 2.47% interest rate (IRC Sections 7872 and 1274; Revenue Ruling 2013-12, I.R.B. 2013-24, May 17, 2013).

Alternatively, the promissory note could be created as a demand note, which would require the short-term rate, but that rate would be reset semi-annually (IRC Section 7872(e)(2)). (Treasury Regulation Section 1.7872-13 provides for an annual blended rate published by the IRS for demand loans in effect for the entire calendar year.) With the current short-term required rate at 0.18%, we believe subjecting the note to the risk of rate increases, with very little improvement possible on the current rate, would seem inadvisable. In addition, term notes can be potentially refinanced if rates drop further or if the end of the term is reached and an extension is necessary. Repeated refinancing with each drop in rates, however, might create audit risk (see the March 2013 Hawthorn white paper, *Estate Planning After ATRA: A Summary of the Heckerling Institute on Estate Planning*, p. 10).

With current low interest rates, a straight loan of cash to a Family Opportunity Trust could provide a straightforward wealth transfer opportunity. For example, if a grantor lends $1 million to his or her Family Opportunity Trust for a

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2 Private letter rulings are not binding on the IRS, but under the Taxpayer Bill of Rights they can be cited for support by a taxpayer to avoid penalty and interest on disputed tax liabilities.
three-year term, taking back a three-year promissory note with a 0.18% interest rate, and the trustee invests the $1 million in a reasonably low-risk investment yielding 2.18%, the 2% spread inures to the benefit of the trust. Of course, transferring high growth potential assets, rather than cash, to a Family Opportunity Trust in exchange for a promissory note creates far greater wealth transfer potential.

Promissory Note Criteria
To be respected as a sale rather than a disguised gift, the grantor’s transfer of assets to a Family Opportunity Trust in exchange for a promissory note must satisfy the same specific criteria as a bona fide sale. Otherwise, the IRS could potentially recharacterize the transaction as a gift, or part sale and part gift, resulting in a taxable gift requiring the use of all or a portion of the grantor’s remaining gift tax and GST tax exemptions, payment of gift tax liability (and possibly GST tax liability), or both.

Along these lines, the promissory note should be in writing, have no provisions that would prevent enforcement in the event of default, and provide for at least the required interest rate for intra-family loans.

In addition, the promissory note must be secured by collateral or guaranties. In the case of those who have established Family Opportunity Trusts and gifted all or a portion of their gift tax and GST tax exemption amounts to the trust, such gifted amounts provide so-called “seed” assets to collateralize a promissory note to purchase additional assets from the grantor.

IRS Private Letter Ruling 9535026 approved a transaction wherein a grantor gifted assets to an IDGT that equaled 10% of total assets when including the additional assets subsequently purchased by the trust from the grantor in exchange for a promissory note, resulting in a 9:1 debt to equity ratio. This seed gift amount sufficed to collateralize the note without negative comment from the IRS in this ruling.

A 9:1 debt-to-equity ratio in this type of transaction can find further support in Section 2701(a)(4) of the Internal Revenue Code, which requires that common stock in a corporation, or subordinated equity in a partnership, with respect to a family entity that is transferred to a child or grandchild must be valued for federal transfer tax purposes at an amount equaling at least 10% of the sum of the equity and debt of the entity.

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23 Although the Internal Revenue Code does not specify what these requirements are, general guidelines have evolved through various court rulings, IRS rulings, and derivation from general federal tax law principles.

24 Some commentators suggest an interest rate above the required intra-family loan rate in order to bring the transaction more in line with what a third-party sale transaction would resemble.

25 Although this paper focuses on trust assets collateralizing the promissory note, particularly because the example of a gift to the trust using the grantor’s (and possibly the grantor’s spouse’s) gift tax and GST tax exemptions is generally presumed, an alternative might be having the trust beneficiaries personally guaranty the trust’s note to the grantor, particularly if the beneficiaries own substantial assets outside of the trust to legitimately do so.

26 Private Letter Rulings are not binding on the IRS but do represent its thinking at that time and can be relied upon by taxpayers to avoid penalty and interest on disputed transactions.
Although the 10% collateralization requirement seems to be the commonly relied upon minimum standard for sales to IDGTs, some in the estate planning community suggest a lower collateralization may be possible. In *McDermott v. Commissioner*, 13 T.C. 468 (U.S. Tax Court 1949), acq. 1950-1 C.B. 3, the U.S. Tax Court approved, and the IRS acquiesced, a transaction involving a much lower 5.6% collateralization, or a 19.6:1 debt-to-equity ratio.

**Example of a Straightforward Sale**

As a hypothetical example of a straightforward sale to a Family Opportunity Trust, assume grantor transfers $10 million to a Family Opportunity Trust, to which his wife consents, utilizing $5 million each of their federal gift tax and GST tax exemptions. The grantor could then sell as much as $90 million of additional assets (a 9:1 debt to equity ratio) in exchange for a promissory note with a nine-year term at the required 0.95% interest rate for midterm loans in June 2013. The promissory note could be structured to provide for interest only, equaling $855,000 annually, with a balloon payment at the end of the term. The interest payment to the grantor would not be taxable income to him or her, but whatever taxable interest, gains, or other tax items were earned by the trust assets would be taxable to the grantor on his or her personal tax return. At the end of the nine-year term of the promissory note, the trust could repay the $90 million balloon principal amount in cash or in kind (that is, with actual trust assets). Paying off the balloon amount in kind would not create any federal taxable gain or loss to the grantor or the trust as they are treated as the same person for federal income tax purposes. Assuming a 5.95% annualized rate of return on the trust assets, the transaction can be summarized in Chart 4.

**Chart 4**

**Sale of Assets to a Family Opportunity Trust**

<table>
<thead>
<tr>
<th>Step 1</th>
<th>Grantor and Spouse</th>
<th>$10 million gift</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 2</td>
<td>Grantor</td>
<td>$90 million sale</td>
</tr>
<tr>
<td></td>
<td>$90 million promissory note</td>
<td>9-year term; interest only at .095%</td>
</tr>
<tr>
<td>Step 3</td>
<td>Grantor</td>
<td>$90 million balloon payment (cash or in-kind)</td>
</tr>
<tr>
<td>(9 years later)</td>
<td></td>
<td>Family Opportunity Trust</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$68,427,247 remaining in trust after balloon payment</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5.95% rate of return</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5.8% internal rate of return (with compounding)</td>
</tr>
</tbody>
</table>

Source: Hawthorn/Babitz/Petrunia

27On the other hand, adhering to a 10% collateralization standard, if not higher, seems advisable in order to avoid being singled out for audit from the many other transactions following the more common 10% standard.
Building upon this basic structure, a grantor might instead sell valuation-discounted assets, such as limited partnership interests in an FLP, to further enhance the leverage available in the sale transaction.

As a hypothetical example, assume that, following the $10 million gift in the above example, grantor creates a single-member LLC, contributing $1,363,630 of commercial real estate assets in exchange for 100% of the membership interests in the LLC. The grantor then creates an FLP, contributing additional commercial real estate properties valued by a professional valuation firm at $135 million in exchange for the 99% limited partnership interests and the LLC contributing its $1,363,630 of assets for the 1% general partnership.

The grantor then sells, with unanimous consent of the partners (that is, grantor and the LLC), his 99% limited partnership interests to the Family Opportunity Trust, taking a 33.33% valuation discount for lack of marketability and control with respect to those interests as restricted by the limited partnership agreement. Accordingly, the value of the limited partnership interests sold to the trust for purposes of this transaction is $90 million. The grantor receives a nine-year term promissory note for $90 million with interest only at the required 0.95% rate, and a balloon payment at maturity.

The FLP (managed by the LLC, owned by the grantor, as general partner) distributes a sufficient portion of the rental cash flow from the properties to the partners (including the trust as a 99% partner) to allow the trust to make its $855,000 interest payment obligation to the grantor each year. At the end of the nine-year term, the trust transfers a portion of its assets, which have appreciated in value, to satisfy the balloon principal obligation in termination of the note, applying the same 33.33% valuation discount to the limited partnership assets (no gain or loss is recognized on this transfer in satisfaction of the note because the trust is a grantor trust for income tax purposes).

Assuming the $10 million seed gift amount is invested in marketable securities and grows at 5.95% annually as in the above example, and the commercial real estate in the FLP appreciates at 9.95% annually, the transaction is summarized in Chart 5(page 15).

Enhancing the Opportunity in 2013 and Beyond
The ability to further add to the Family Opportunity Trust through the annual inflation adjustment increase to the gift tax exemption and GST tax exemption provides, in our view, substantial possibilities for additional leveraged wealth transfer. For example, in 2013 the inflation adjusted increase to the gift tax and GST tax exemptions is $130,000, or $260,000 for a married couple (Revenue Procedure 2013-15, I.R.B. 2013-5, Section 2.13, January 11, 2013). Each year, additional amounts will become available through the inflation adjustment to the gift tax exemption and GST tax exemption.

The additional $260,000 of lifetime gift tax and GST tax exemptions could be used to gift valuation discounted assets such as limited partnership interests.

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28 This valuation, obtained from a professional valuation expert specifically for wealth transfer purposes, will likely and ideally be at the lower end of a reasonable range of values.
29 By having an LLC, rather than grantor, own the general partnership interest, grantor is protected from personal liability exposure that a general partner may be subject to with respect to the assets and activities of the FLP.
30 Recall that additional annual gift tax exclusion gifts to a Family Opportunity Trust are not practical because of the unavailability of the corresponding annual GST tax exclusion.
in an FLP. At a 35% valuation discount for lack of marketability and control with respect to such interests, $400,000 of actual value could be transferred to the trust.

The $260,000 of additional exemption could also be used to make an additional seed gift to the trust, providing the 10% collateralization discussed above for an additional sale of as much as $2.34 million of assets to the trust in exchange for a promissory note (or $3.6 million of assets that are discounted in value by 35%). Thus, each year, the inflation adjusted increases to the gift tax and GST tax exemptions could form the basis of substantial additional wealth transfer to the Family Opportunity Trust.

The Promissory Note: Other Considerations
Payments received by the grantor from the trust with respect to the promissary note come back into his or her taxable estate. To the extent those payments are not spent (such as for the grantor’s lifestyle needs and desires), gifted (such as by utilizing annual gift tax exclusions, and possibly annual GST tax exclusions), or perhaps contributed to charitable causes, such payments and their growth will be subject to federal estate tax upon the grantor’s death. For a married grantor, these federal estate tax consequences can be deferred until the death of the survivor of the grantor and grantor’s spouse by using the unlimited marital deduction under IRC Section 2056.
In addition, if the grantor dies before the termination of the promissory note (for example, prior to the end of the nine-year term in the above examples), the remaining value of the promissory note is included in his or her taxable estate as well.\(^{31}\)

We believe there is one additional income tax issue that may be problematic in the event the grantor dies prior to termination of the promissory note, based on the fact that the trust’s grantor trust status for federal income tax purposes ends upon the grantor’s death. Grantor trust status is what protects the transaction from being subject to recognition of federal capital gains tax on the appreciation of the assets over their cost basis at the time they are transferred to the trust. Accordingly, payments received after the grantor’s death could potentially be subject to capital gains taxation. This would be the case if the sale were considered an installment sale for income tax purposes in which gain is recognized as principal payments are received (IRC Section 453).

Although sales providing for deferred principal payments under a note are generally treated as installment sales (IRC Section 453(a)), one can elect out of installment sale treatment (IRC Section 453(d)), in which case the gain on the transaction would be realized in full at the time of the initial sale transaction when the grantor is alive and the trust’s grantor trust status would prevent recognition of capital gain tax liability.

The risk of inclusion of the promissory note’s remaining value in the grantor’s taxable estate should he or she die prior to its termination (as well as the corresponding above-noted capital gain taxation risk) can be mitigated or eliminated. That is, the promissory note could be structured such that it will terminate upon the death, or premature death, of the grantor. The two most common approaches to accomplish this result are a Self-Cancelling Installment Note (SCIN) or a private annuity.

**Self-Cancelling Installment Note**

A SCIN is a promissory note that generally carries a provision that the note will terminate should the grantor die prior to the scheduled end of its term. This design is intended to cause the note to be worth zero upon the grantor’s death. With no value for the note at grantor’s death, nothing is includible in the grantor’s taxable estate.

For the SCIN to be respected as full consideration and equal value received by the grantor in exchange for the assets transferred to the trust (thereby avoiding a taxable gift by the grantor to the trust as to the deficiency of the value of the note relative to the assets transferred), some premium must be included to compensate the grantor for the mortality risk in the form of a higher principal.

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\(^{31}\)Some commentators believe that the value of the note might be discounted for estate tax purposes if the interest rate on the note is low relative to prevailing interest rates at date of death or based on less-than-ideal collateralization, or both. See Treasury Regulation Section 20.2031-4, generally allowing for discounting the value of a note held by an estate if executor establishes that it has a value below the amount of remaining principal plus accrued interest. Although proposed Treasury Regulation Section 20.7872-1 disallows valuation discounting, for estate tax purposes, of a gift loan, such regulation presumably does not apply in the case of a note received in a sale of assets, which is not a gift for tax purposes.

\(^{32}\)For further information on this issue, see Manning and Hesch, “Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements,” Tax Management, Estate, Gifts and Trust Journal 3 (1999).
amount or higher interest rate, or both. Calculation of the appropriate premium as to increased principal amount of the note or higher interest rate, or both, requires the proper guidance of legal, tax, and valuation advisors.

**Private Annuity**
A private annuity involves designing the note to amortize principal and interest on the note over the grantor’s life expectancy in the same way a commercial annuity might be structured. Although the advantageous low intra-family interest rates noted above can be used, the highest, long-term rate (currently 2.47%) must be used if the grantor’s life expectancy is greater than nine years. Further, the required annual payments of principal and interest will be significantly greater than an interest-only note would entail. This would require a greater transfer of cash or assets from the trust each year, which could impair the growth of the trust assets as compared with a back-ended balloon note.

**Comparison with GRATs**
A commonly used wealth transfer technique, Grantor Retained Annuity Trusts (GRATs) are comparable to sales of assets to IDGTs (that is, Family Opportunity Trusts). A GRAT is a special type of irrevocable trust (treated as a grantor trust for income tax purposes) to which the grantor transfers assets and receives a fixed annuity for a term of at least two years (IRC Section 2702). The annuity amount can increase by as much as 20% annually (Treasury Regulation Section 25.2702-3(b)(1)(ii)).

The value of the annuity is reduced from the value of the assets transferred to the GRAT to determine the value of the taxable gift. Accordingly, if the value of the annuity equals or exceeds the value of the assets transferred, there is no taxable gift. This type of GRAT is often referred to as a Zeroed-Out GRAT. A Zeroed-Out GRAT is comparable to the sale of assets to an IDGT because assets are transferred to a grantor trust in exchange for a “note” (the required fixed annuity) of equal value, and thus there is no taxable gift.

The value of the annuity is determined based on IRS Tables using 120% of the midterm interest rate, rounded to the nearest 0.2%, required for intra-family loans (IRC Sections 2702(a)(2)(B) and 7520(a)(2)). Thus, the rate for June 2013 is 1.2% (120% of the 0.95% midterm intra-family loan interest rate for June 2013, as rounded) (Revenue Ruling 2013-12, I.R.B. 2013-24, May 17, 2013, Table 5).

If the grantor dies prior to the end of the annuity term, the assets are included in his or her taxable estate (IRC Section 2036(a)(1)). Some commentators assert, however, that only a fractional pro rata portion of the trust assets, based on the remaining annuity term at the time of the grantor’s death, should be included in his or her taxable estate. At the end of the GRAT term, the remainder of the trust assets can pass outright to the GRAT beneficiaries or remain in further trust for them.

There are a number of advantages of a sale of assets to a Family Opportunity Trust over a GRAT:
GST Tax Exemption Cannot Be Allocated Until End of Annuity Term
GST tax exemption cannot be allocated to a GRAT until the end of the annuity term when the remainder vests in the beneficiaries (IRC Section 2642(f)). This delay in allocating GST exemption is known as the estate tax inclusion period, or ETIP. Without knowing what the value of the GRAT assets will be in the future when the annuity term ends, GST tax exemption may either be overallocated, resulting in wasted GST tax exemption, or underallocated, resulting in GST tax liability. As a result, GRATs are not generally effective or efficient tools for multigenerational wealth transfer but rather are typically limited to transfers to children.

On the other hand, GST tax exemption can be immediately allocated to the seed gift made to the Family Opportunity Trust (and the subsequent sale of assets is not a gift and thus does not require allocation of GST tax exemption). Accordingly, the grantor can make the trust completely GST tax exempt through precise allocation of GST tax exemption to the gift amount of the transaction at its outset (and prior to appreciation of the trust assets). As a result, the trust assets, and their growth, can be excluded from the taxable estates of multiple generations of the grantor’s descendants.

Amount of Required Payments to Grantor Is Greater
The interest rate used in calculating the GRAT annuity is 120% of the midterm rate for intra-family loans used in determining the minimum interest rate on a three- to nine-year term promissory note that might be used in the sale of assets to a Family Opportunity Trust. (Note that the intra-family interest rate for a promissory note would be lower or higher than the midterm rate if a shorter term of less than or equal to three years, or longer term greater than nine years, is used.) As a result, a greater amount of payments back to the grantor is required with a GRAT, thereby diminishing the growth of the trust assets outside of the grantor’s taxable estate.

Promissory Note Can Be More Flexible
The promissory note transferred by the trust to the grantor in an exchange for the grantor’s sale of assets to a Family Opportunity Trust can be far more flexible than the fixed annuity payments, with limited variance, required with a GRAT. The promissory note can provide for annual interest-only payments with a balloon payment of the entire principal at maturity. This back-end loading of the note allows for the possibility of greater growth of the trust assets, undiminished by principal payments, for a longer period of time. Assuming a positive rate of return on the trust assets, there will be a greater amount of assets in the trust at the end of the term of an interest-only balloon note as compared to a fixed GRAT annuity requiring amortizing payments of both interest and principal annually.

Grantor Must Survive Annuity Term
The grantor must survive the annuity term of a GRAT in order to exclude the remaining GRAT assets from his or her taxable estate. With a sale of assets to a Family Opportunity Trust, the transferred assets are immediately removed from the grantor’s taxable estate. Of course, as discussed above, the value of the promissory note, if any, will be included in the grantor’s taxable estate at death.

Correspondingly, there are disadvantages to a sale of assets to an IDGT over a GRAT:
Sale to a Trust Involves Additional Risk

A GRAT is specifically sanctioned by the Internal Revenue Code (IRC Section 2702). The only audit risk for a GRAT, provided it is properly drafted, is valuation of the transferred assets. The sale of assets to a Family Opportunity Trust, on the other hand, relies upon principles derived from a few court cases and IRS rulings as well as federal tax law principles. Consequently, such transactions carry greater risk and require careful attention to detail and structure from qualified tax and legal advisors.

Greater Valuation Risk

There is greater valuation risk associated with the assets sold to a Family Opportunity Trust than with a GRAT. If the value of assets transferred to a GRAT is disputed by the IRS, and ultimately an adjustment is made, a properly drafted GRAT will contain a provision, allowed by the Internal Revenue Code, that will correspondingly increase the required annuity distributions to the grantor for the balance of the term to the exact amount necessary such that there will not be any additional taxable gift (Treasury Regulation Section 25.2702-3(b)(1)(ii)(B)).

In the case of a sale of assets to a Family Opportunity Trust, on the other hand, should the IRS prevail in increasing the value of the transferred assets, that additional value would exceed the value of the note and will constitute a taxable gift. This risk is especially significant when difficult-to-value assets, such as real estate or FLP interests, are transferred.

Along these same lines, the IRS could conceivably challenge the structure of the promissory note as to interest rate, the premium charged in the case of a SCIN, or other criteria, resulting in a reduced value of the note and a corresponding taxable gift with respect to the resulting excess value of the assets sold to the trust in exchange for the devalued note. The determination of the required GRAT annuity, on the other hand, is fixed by the Internal Revenue Code and corresponding IRS Tables. Therefore, such risk is generally not an issue for a GRAT for which the required annuity is properly calculated under applicable IRS Tables.

No Downside Risk

There is no downside risk if the assets transferred to a GRAT underperform below the “hurdle rate,” the required interest rate used in determining the required annuity payments and term. Even though the current hurdle rate is a low 1.2%, the GRAT assets could nevertheless attain a very low rate of return or decline in value. Should the assets underperform or decline in value, the grantor might receive back all of the assets of the GRAT in the form of the required annuity payments (and might, in fact, not ultimately receive all of the

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33 One means of mitigating this valuation risk is by use of a defined value clause such as a formula allocation clause or formula transfer clause. Under such an approach, any excess value of the assets sold to the trust over the principal amount of the note that is successfully asserted by the IRS would instead pass to a gift-tax exempt transferee such as charity, the grantor’s spouse or trust for the spouse qualifying for the marital deduction, a Zeroed-Out GRAT, or back to the grantor. For more information on the use and types of defined value clauses, see the March 2013 Hawthorn white paper. Estate Planning After ATRA: A Summary of the Heckerling Institute on Estate Planning, pp. 6–7. Formula valuation clauses can work especially well with sales of units in family entities such as FLPs.
otherwise required payments should the GRAT run out of assets). In such a case, the GRAT “fails,” but the grantor is in no worse position from a wealth transfer perspective than if he had never established the GRAT at all.

On the other hand, underperformance of assets transferred to a Family Opportunity Trust in exchange for a promissory note can be potentially devastating. For example, assume a grantor sells $10 million of assets to a Family Opportunity Trust in exchange for a $10 million promissory note. During the term of the note, the transferred assets decline 80% in value in the trust. The grantor has accomplished a transfer of $2 million of assets out of his taxable estate to the trust in exchange for an asset worth $10 million (the promissory note) in his taxable estate. If the note is nonrecourse, however, then perhaps there may be no further adverse consequence if the grantor can successfully argue that the note is worth no more than the assets of the trust.

**Danger Ahead — Not-So-Permanent Permanent Estate Tax Reform**

On April 10, 2013, the Obama administration released its 2014 budget. The budget contained a number of Treasury Department tax legislation proposals. These proposals are typically referred to as the Greenbook.

One item, not included in previous Greenbooks, is a proposal to effectively eliminate the use of IDGTs as wealth transfer vehicles. In essence, the proposal would include in a grantor’s taxable estate the assets of any trust that is treated as a grantor trust for income tax purposes. Further, any distributions from such a trust during the grantor’s lifetime would be treated as taxable gifts by the grantor to the beneficiary.

This proposal would seemingly be prospective only, taking effect, at worst, on the date such proposal is actually introduced in either chamber of Congress or the later date of its enactment into law. Accordingly, those IDGTs in effect as of such date would likely be grandfathered and retain their status as defective grantor trusts that can be excluded from the grantor’s taxable estate.

In addition, the Greenbook’s proposals include a provision that would limit the GST tax-exempt status of any trust to 90 years from the date of its creation, thereby restricting the estate exclusion of assets of any trust to approximately two or three generations. Again, the effective date of such a revision to the Internal Revenue Code would likely be prospective only, from the date of its introduction in Congress or its date of enactment forward, with trusts created prior to that date exempted from this provision. Analogously, note that multigenerational trusts in place prior to the Tax Reform Act of 1986, which enacted the GST tax, are generally exempt from this tax and the requirement of allocating GST tax exemption in order to attain GST exempt status.

The recent Greenbook proposals also once again contain provisions to substantially restrict the benefits of GRATs. Such provisions would require prospective GRATs to contain a minimum annuity term of 10 years, would...
not permit declining annual annuity payments, and would not allow for Zeroed-Out GRATs.

Also, the Greenbook would modify the permanence of the recent favorable codifications of the $5 million exemption, adjusted annually for inflation, for the federal estate, gift, and GST taxes, as well as the 40% top rate for these taxes. Commencing in 2018, the exemptions for these transfer taxes would drop to $3.5 million, not indexed annually for inflation, and the top rate would increase to 45% (these were the exemption amount and top rate in effect for 2009).

In what some might perceive as a favorable development, for the first time since before the Clinton administration, a Democratic president’s budget does not call for the elimination or substantial restriction of valuation discounts for limited interests in family entities such as FLPs for transfer tax purposes. Nevertheless, some commentators have expressed concern that the absence of such a proposal signals the Obama administration’s intention to directly eliminate or restrict such valuation discounts through Treasury regulations to the Internal Revenue Code.

We believe the level of the president’s influence with Congress (and the American people) over the balance of his final term, combined with the outcome of next year’s midterm elections and whether the House of Representatives remains under Republican control, will affect the possibility of any or all of the above Obama administration legislative proposals coming to fruition.

Of course, Congress cannot prevent changes in IRS regulations that might affect valuation discounts with respect to family entities such as FLPs other than by amending the Tax Code to overturn them. The recent IRS targeting controversy, however, may adversely affect that agency’s ability to effect major regulatory changes over the balance of President Obama’s term in office.

Regardless of the political climate over the next few years, we view as a certainty the continuing pressure that the substantial annual budget deficits and growing national debt will continue to place on Congress and the president. There are many representatives in Congress as well as other influential circles who do not believe that tax increases will be as effective as spending cuts to attack the deficits and debt, or who assert that the federal transfer taxes account for a very small percentage of revenue. Nevertheless, any action in this area may well be perceived favorably as steps toward attacking the debt crisis (and as actions that will affect only a small percentage of the electorate). Accordingly, we suggest that individuals and their advisors seriously consider taking action sooner rather than later to take advantage of the wealth transfer opportunities available with Family Opportunity Trusts and the related techniques discussed in this paper.

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36 According to IRS publications, the estate tax and gift tax make up about 1% of total tax receipts and have generally been in a range of 1–2% since World War II.
Conclusion
A Family Opportunity Trust represents, in our opinion, an ideal vehicle for wealth transfer. In addition to managing, protecting, preserving and growing family wealth for generations to come, such a trust provides the opportunity for substantial, leveraged wealth transfer in concert with the current advantageous federal gift tax exemption and GST tax exemption, as well as the availability of related techniques to amplify their value.

For those who have established Family Opportunity Trusts, the capacity both to magnify the transfers already made and make additional leveraged wealth transfers on an annual basis is in place. For others, the opportunity to establish and maximize the value of such a trust for the benefit of one’s family, both now and for generations to come, is knocking at the door. We believe that individuals may want to consider acting soon because forces in Washington may close this door, partially or completely, in the not-too-distant future.
Leveraging the Trust

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