Wealth transfer planning alternatives

In the prior release of our wealth planning guide, we discussed how important it is to periodically reevaluate your wealth transfer goals and revisit your wealth transfer plan for consistency with those goals. We also addressed how effective wealth transfer planning facilitates how to “slice up the pie” of your wealth between family and friends, charity, and the government (in the form of taxes). We provided you with a primer on the transfer tax system, covering the three related federal transfer taxes—the gift tax, the estate tax, and the generation-skipping transfer (GST) tax—as well as state transfer taxes. The prior release covered the basic concepts of wealth transfer planning. This release revisits those fundamental concepts, with appropriate illustrations, and discusses how they are frequently combined into many of the common planning alternatives available today. You may find it instructive to first review the foundational wealth transfer planning chapter from our first installment before exploring this wealth transfer planning alternatives chapter.
On December 22, 2017, an Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (the Act) was signed into law. Under this new legislation, the current tax regime with respect to the estate, gift, and GST taxes and the income tax basis adjustment to fair market value at death remain unchanged. The only exception is that the applicable exclusion amount (the amount that each citizen is entitled to transfer either during life or, if otherwise unused, at death without incurring a current tax) and the GST tax exemption (the amount that may be transferred to skip-persons outright or in trust without giving rise to a present or future GST tax) is doubled to $10 million per person (indexed for inflation) from its existing $5 million per person (indexed for inflation) for transfers occurring after December 31, 2017. The exclusion and GST exemption continue to be indexed for inflation. As the Internal Revenue Service (IRS) recently announced, the inflation adjusted amount for 2018 is $11,180,000. However, beginning January 1, 2026, the exclusion amount and the GST exemption will return to the levels that would have prevailed under prior law.

For married couples expecting to have collective wealth in excess of approximately $12.5 million at the end of 2025, the Act provides a tax incentive to proactively plan now. Perhaps now is the time to take a fresh look at your tax and wealth planning objectives to refocus on what is most important—your family, business, and personal goals—in anticipation of impending change.

Our overriding intention for this release is to reiterate the concepts that form the “how” of wealth transfer as commonly considered by high net worth families to further inform the more personal considerations of “to whom” and “when” such transfers of wealth should occur. Importantly, every concept can be employed in multiple variations and combinations that are beyond the scope of this release. Not all of the concepts or examples provided in this release may be appropriate for everyone, and there may be other concepts not discussed in this release that may be more suitable for your particular goals and circumstances. For example, with the new larger exemption amounts, perhaps transfer planning is no longer as expedient; but, there is still income tax planning that should be considered—a topic for another release. Whether or not to employ one or more of the concepts is a function of the nature of the assets that comprise your wealth, your objectives regarding to whom, how, and when to convey those assets, and your overall risk tolerance. Merely reading this release is not a substitute for engaged and thoughtful planning with your tax advisers.
Wealth transfer planning alternatives

Concepts for consideration

In this chapter we provide an overview of the following wealth transfer planning concepts:

1. Transfers through arbitrage—the use of preferred equity interests
2. Transfers of actuarial interests, arbitrage in a different form—the grantor retained annuity trust (GRAT)
3. Transfers through leverage—the sale to a grantor trust
4. Leveraged transfers of actuarial interests, combining two alternatives—the remainder purchase marital (RPM) trust

For each concept, we provide an example of one way it could be structured, along with comments about transfer tax issues, and in some cases, income tax concerns.

In addition, we reiterate two other concepts often used to supplement planning as circumstances permit:

- The net gift (and bargain sale) concept
- The use of formula valuation mitigation clauses

Note that for each concept, we present selected benefits and risks, which are by no means exhaustive. Readers should consult their advisers concerning the benefits and risks arising with respect to their own assets, goals, and circumstances.
Wealth transfer planning alternatives

Transfers through arbitrage: The use of preferred equity interests

A cautionary note: Establishing family investment entities, with or without multiple equity classes, has long been an object of intense IRS scrutiny. Using these vehicles requires scrupulous adherence to the entity’s governance provisions, and more importantly, based on recent case law, must be found to have been established and funded for a nontax purpose that is evident from the conduct of the parties. Typically, this requires a significant differentiation in asset management before and after the creation and funding of the entity. Failure to exhibit these qualities will result in the assets contributed to such an entity being included in the taxable estate of the contributor at their fair market value at death. The success of family investment entities can be a point of great risk without the support of a family office structure. Nevertheless, they do best illustrate the concept behind the alternative of moving wealth by arbitrage.

At the outset, the family contributes property to a family-controlled limited partnership or limited liability company (LLC). The senior generation typically receives the general partner (GP) units or managing member LLC units (typically, 1 percent of the capital and income). The limited partner (LP) units (or nonmanaging member LLC units) are divided into two classes: preferred and residual. Who comes to own the preferred and residual units depends on the alternative employed.

Preferred units typically have liquidation participation rights, but generally not a liquidation preference, and a set annual cumulative payout rate that is a stated percentage of the liquidation value. For example, a preferred unit may have a liquidation value of $100 and a preferred payment rate of 8 percent, meaning that each year the preferred unit is expected to pay $8 to its holder. To avoid adverse gift tax consequences, the annual payment, if not made, will accumulate for later payment before the residual owners are paid. The residual units receive what is left of any annual distribution. Upon liquidation, any cumulative deferred payment is made to the preferred unit holders; thereafter, the preferred units participate proportionately in the liquidation proceeds, but not in excess of their liquidation value.

The preferred payment rate is determined by an independent appraiser. The preferred rate is fundamentally based upon an analysis of market corollaries, considering the relative risk profile and credit quality of the interest. The object of the analysis is to reflect a rate of return that preserves the liquidation value of the preferred units. Given prevailing interest rates over the past decade, that preferred rate has ranged between 6 and 10 percent and is trending higher.
Wealth transfer planning alternatives

Transfers through arbitrage: The use of preferred equity interests

The forward arbitrage structure
To arbitrage forward, the senior generation family members obtain the preferred units generally in exchange for capital contributions, and the junior generation obtains the residual units either by capital contribution or by gift from the senior generation. This configuration provides a preferential cash flow stream to the senior generation while shifting future appreciation and/or income generation in excess of the preferred rate to the junior generation. The value of any gift of residual units is generally determined by taking into account discounts for lack of marketability and lack of control (which are frequently a matter of contention with the IRS) and also the value of the preferred equity class.

Proper structuring of a forward arbitrage is essential to gain the intended benefits. Internal Revenue Code (IRC) section 2701 mandates the necessary provisions with respect to family-controlled entities having multiple equity classes. If these requirements are not met, significant valuation complications are imposed and a significant gift tax can result. The requirements are beyond the scope of this release; please consult with your tax adviser for additional details.

While there are no constraints on the types of assets or business activities that can be undertaken by the partnership or LLC, once again, what is important is that appreciation or income production outpace the preferred payout rate. Preferably, cash flow will permit the payment of the preferred return on a relatively current basis rather than only at liquidation. Current law requires that any cumulative but unpaid preferred return, including compound interest in certain circumstances, be treated as a separate asset if unpaid at the date of a gift of the preferred interests or upon the holder’s death.

Forward arbitrage partnership (FAP) illustration

1. Contribute cash or other property to FAP in exchange for GP interest and preferred LP units and, if circumstances require, residual LP units

2. Senior family member transfers any acquired residual LP units to junior generation

Trust(s)

Senior family member

Junior family members

FAP

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Transfers through arbitrage:
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Forward arbitrage structure select benefits and risks

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<thead>
<tr>
<th>Select benefits</th>
<th>Select risks</th>
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<tbody>
<tr>
<td><strong>Cash flow to senior generation</strong> – Provides the preferred unit holders with annual cash flow.</td>
<td><strong>Proper structuring</strong> – Complying with section 2701 requirements is necessary to avoid adverse gift tax consequences.</td>
</tr>
<tr>
<td><strong>Appreciation to junior generation</strong> – Allows appreciation/income generation above the preferred rate to the residual unit holders.</td>
<td><strong>Asset performance</strong> – If the partnership asset performance is less than the preferred rate, any gifted residual units may prove to be valueless and, if junior family members contributed to the residual units, a reverse wealth transfer may result.</td>
</tr>
<tr>
<td><strong>Control</strong> – Although not generally advisable, senior generation can control through ownership of general partnership units.</td>
<td><strong>Complexity</strong> – Structure requires an outside appraisal, annual partnership tax returns reflecting complicated partnership income allocation issues, and a more complicated gift tax return. Involves strict adherence to the governance provisions of the LP or LLC agreement.</td>
</tr>
<tr>
<td><strong>Valuation discounts</strong> – Valuation discounts may be available to reduce the gift tax value of transfers of residual units by gift, if any.</td>
<td><strong>Costs and administration</strong> – Includes more significant setup and administration, which may increase transaction costs.</td>
</tr>
<tr>
<td><strong>Flexibility</strong> – While a four-year grace period is allowed to make preferred payments, providing for greater flexibility with cash flow fluctuations, the cumulative unpaid amount, plus compound interest if the four-year grace period is exceeded, is treated as a separate asset that has both gift and estate tax implications.</td>
<td><strong>Risk profile</strong> – IRS may challenge the value of the preferred equity interests or the valuation discounts applied to transfers of the residual units. Either argument, if it prevails, may result in additional gifts and additional transfer tax. Additionally, whether the transfer was ultimately effective will turn on whether estate inclusion of contributed assets can be avoided.</td>
</tr>
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Transfers through arbitrage: The use of preferred equity interests

The reverse arbitrage structure

In a reverse arbitrage, the senior generation retains the residual interest, and the junior generation—through capital contributions or by transfers from the senior generation—receives the preferred LP or nonmanaging member units. The alternative, when structured in this manner, is not subject to the statutory constraints of the forward arbitrage structure. Thus, the preferred units are frequently structured to convey an above-market return (for example, by imposing an above-market hurdle rate that is generally noncumulative). This, too, should be set by an appraiser since fair market value becomes less sensitive to higher hurdle rates depending on the assets contributed to the entity. In all other respects, they resemble the preferred units in the forward arbitrage structure.

The structure anticipates that the high preferred rate will consume most (if not all) of the partnership’s appreciation and income generation, resulting in the residual interest retained by the senior generation actually experiencing little growth and perhaps a diminution in value between the date of transfer and the senior generation unit holder’s death. More importantly, this structure transfers cash flow to junior family members (or their trusts), which may make additional planning easier to undertake (such as sales to grantor trusts). The value of any gift of preferred units is generally determined by taking into account discounts for lack of marketability (which are generally modest given the hurdle rate) and lack of control (which is an issue if the preferred return is not cumulative). As stated earlier, discounts are frequently a matter of contention with the IRS. Structured in this manner, the relative gift value of preferred units is generally relatively high.

Again, while there are no constraints on the types of assets or business activities that can be undertaken by the partnership or LLC, what is important is that the preferred interest holders receive their anticipated above-market yield. This puts an emphasis on annual cash flow since the preferred yield is not generally cumulative—thus, cash flow planning is crucial.

Reverse arbitrage partnership (RAP) illustration

1. Contribute cash or other property to RAP in exchange for GP interest and residual LP units and, if circumstances require, preferred LP units
2. Senior family member gifts any acquired preferred LP units to junior generation

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Transfers through arbitrage: The use of preferred equity interests

Reverse arbitrage structure select benefits and considerations

<table>
<thead>
<tr>
<th>Select benefits</th>
<th>Select risks</th>
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</thead>
<tbody>
<tr>
<td><strong>Section 2701 rules don't apply</strong> – A reverse arbitrage structure is not subject to the section 2701 considerations.</td>
<td><strong>Cash flow to senior generation</strong> – This alternative provides NO cash flow to the senior generation.</td>
</tr>
<tr>
<td><strong>Cash flow to junior generation</strong> – Provides the preferred rate cash flow to the preferred unit holders.</td>
<td><strong>Asset performance</strong> – If the partnership asset performance is greater than the preferred payments, the wealth of the senior owners will increase.</td>
</tr>
<tr>
<td><strong>Control</strong> – Although not generally recommended, senior generation can still control through ownership of general partnership units.</td>
<td><strong>Complexity</strong> – Structure requires an outside appraisal, annual partnership tax returns reflecting complicated partnership income allocation issues, and a more complicated gift tax return. Involves strict adherence to the governance provisions of the LP or LLC agreement.</td>
</tr>
<tr>
<td><strong>Valuation discounts</strong> – Valuation discounts may be available to reduce the transfer tax value of residual units held by the senior generation at death.</td>
<td><strong>Costs and administration</strong> – Includes more significant setup and administration, which may increase transaction costs.</td>
</tr>
<tr>
<td><strong>Flexibility</strong> – There are no required annual payments; however a failure to make annual payments can affect the efficacy of the alternative since the preferred payments are not cumulative.</td>
<td><strong>Risk profile</strong> – IRS may challenge the value of the preferred equity interest resulting in additional gifts, including potential gifts from junior family members to senior family members. Additionally, whether the transfer was ultimately effective will turn on whether estate inclusion of contributed assets can be avoided.</td>
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</table>
A GRAT is an irrevocable trust to which the grantor contributes property and retains a fixed annuity, payable in cash or in kind, from the trust for a term of years. The remainder interest (the property that remains in the GRAT after the final annuity payment is made) is distributed to the specified beneficiary, typically the grantor’s children or trusts for their benefit. As will be evident below, GRATs can be funded with extraordinary amounts, yet result in very small taxable gifts. They are not a substitute for, but rather augment, the judicious use of a taxpayer’s applicable exclusion amount.

In its most common iteration, the “zeroed-out” GRAT or Walton GRAT, the calculated present value of the retained annuity payments flowing to the grantor generally equals, within a few dollars, the value of the property he or she contributed. The gift subject to tax is the current value of the remainder interest in the GRAT transferred to the beneficiary—the value of the assets contributed to the GRAT less the present value of the retained annuity. If the value of the retained annuity is essentially equal to the value of the property contributed, a minimal gift results. The present value of the annuity payments is calculated using a prescribed discount rate updated monthly by the IRS. That rate is 3 percent for March 2018 (its historical high was 11.6 percent in May 1989).

As a cautionary note, when a trust is established fundamentally for the benefit of its grantor, the trust's assets will be included in the grantor's gross estate should he or she die as a beneficiary of the trust. Thus, should the grantor die while the annuity is still being paid, the desired estate tax savings will not materialize. Most GRATs include short annuity periods to mitigate this mortality risk.

As described above, a Walton GRAT is successful only if the grantor survives the annuity term, and most importantly, if the trust property appreciates and/or generates income at a rate higher than the discount rate noted above. If the trust property fails to outperform the discount rate, the required annuity payments will erode or “cannibalize” the trust. Thus, the GRAT's advantage is in the rate arbitrage between actual yield and the mandated discount rate. However, since the gift tax value of the remainder interest is typically structured to be a modest number, a failed GRAT imposes no significant hardship. Thus, while GRATs are very attractive in the current lower interest rate environment, they still must be funded with assets capable of significant appreciation or income production during the annuity period. For example, in the past this has sometimes been realized with closely held stock in a company anticipating a public offering, or an asset that provides substantial cash flow. Because of the annual payment requirement, if the yearly annuity is to be paid in kind with difficult-to-value assets, such assets will also need to be annually appraised in order to determine that the annuity requirement is met in good faith. Examinations of GRAT transactions by the IRS indicate that the due diligence in determining the amount of any annuity payment in kind will be strictly scrutinized.
Wealth transfer planning alternatives

Transfers of actuarial interests, arbitrage in a different form: The GRAT

For income tax purposes, the GRAT is a grantor trust (discussed in the foundational wealth planning chapter from our first release). Therefore, the grantor continues to report any income attributes of the GRAT on his or her individual income tax return. Since a GRAT itself does not attract income taxes, the GRAT assets grow income tax-free, thus enhancing the probability of a yield in excess of the discount rate.

**Grantor Retained Annuity Trust (GRAT) Illustration**

1. Grantor contributes property to GRAT
2. GRAT makes annual annuity payments to grantor
3. At end of annuity term, any remainder passes to remainder beneficiaries

**GRAT example**

In January 2018, Jack contributes $10 million of appreciated, marketable securities to a GRAT, which was established for the benefit of his daughter, Alyssa. The term of the GRAT is five years and the required discount rate is 2.6 percent. Jack retains an annuity of roughly 14.6 percent of the initial value of the property contributed, which increases by 20 percent each year (the maximum escalation allowed by statute). The present value of the annuity payments is $9,999,999, which results in a gift of $1.

Over the term of the GRAT, the marketable securities appreciate at an annual rate of 6 percent. Accordingly, at the end of the annuity term, which Jack survives, $1,356,438 is left for distribution to Alyssa.

**The result:** Jack transferred over $1.35 million to Alyssa utilizing only $1 of his gift exemption.
Wealth transfer planning alternatives

Transfers of actuarial interests, arbitrage in a different form: The GRAT

GRAT select benefits and risks

<table>
<thead>
<tr>
<th>Select benefits</th>
<th>Select risks</th>
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<tbody>
<tr>
<td>Control – In most cases, the donor can be trustee of the GRAT, but generally</td>
<td>Mortality risk – Grantor must outlive the GRAT term for the GRAT to be</td>
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<td>not beyond the annuity period.</td>
<td>successful.</td>
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<tr>
<td>Tax-free growth – Property in trust appreciates tax-free (because the grantor</td>
<td>Inflexible – Timing and amount of annuity payments are inflexible, and by</td>
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<td>reports the trust’s income on his/her tax return).</td>
<td>statute, the trust cannot be terminated early (commuted).</td>
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<tr>
<td>Minimal cost to failure – If trust property does not perform better than the</td>
<td>Market risk – Because the GRAT remainder interest is so small, volatility,</td>
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<tr>
<td>discount rate, trust assets are returned to the grantor with little or no gift</td>
<td>particularly in the early years, may preclude a GRAT’s success.</td>
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<tr>
<td>tax exemption utilized.</td>
<td></td>
</tr>
<tr>
<td>Limited valuation protection – Expressing the annuity as a percentage of</td>
<td>Limited GST planning – GRATs are most effective for single generation</td>
</tr>
<tr>
<td>initial fair market value allows for automatic adjustment of the</td>
<td>transfers (for example, transfers to children) because GST exemption cannot</td>
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<tr>
<td>determination of the required annuity amounts if valuation is later</td>
<td>be allocated to a GRAT until the end of the annuity period.</td>
</tr>
<tr>
<td>contested.</td>
<td></td>
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<tr>
<td>Risk profile – GRATs and their governance are statutory (IRC section 2702).</td>
<td>Carryover basis – Property received by the remainder beneficiary maintains</td>
</tr>
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<td></td>
<td>carryover tax basis.</td>
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The qualified personal residence trust (QPRT) – an alternative transfer of a future interest

Family members interested in transferring their principal residence or vacation home may want to consider a QPRT. A QPRT performs much like a GRAT except that the annuity payment is replaced by the rent-free use of the residence for the specified term of years. At the end of the term, the ownership of the home typically passes to children. Although one can continue to live in the home after the children take ownership, paying fair market rent will be required to avoid adverse estate tax consequences. QPRTs are more favorable in a higher interest rate environment because higher rates increase the value of the retained use of the residence, thus reducing the taxable gift.
Wealth transfer planning alternatives

Transfers through leverage: The sale to a grantor trust

There are a number of retained interests and powers that give rise to grantor trust status. The grantor trust used in this alternative must, however, employ one of a select subset of retained powers, which enable it to also avoid later estate tax of the trust’s assets. Stated differently, the trust must be regarded as a separate and distinct entity for transfer tax purposes, but be disregarded for income tax purposes. Because the grantor pays all income taxes on the tax attributes of the trust, the trust’s assets grow free of income tax, thus better facilitating the sale transaction discussed below. Income tax paid by the grantor on behalf of the trust further reduces the grantor’s taxable estate.

In many cases, the trust is drafted as a dynasty trust, which as the name implies, typically benefits children, grandchildren, and future generations. In certain states, a dynasty trust can have a perpetual term. Unlike a GRAT, the dispositive terms of a dynasty trust can be very flexible with respect to who benefits from the trust, and to what extent. Such a trust is transfer-tax effective, however, only if it is exempt from the GST tax. To accomplish this, the grantor’s GST exemption must be allocated to each gift transfer made to the trust.

Once the grantor trust is established with sufficient capital (which will utilize some or all of the grantor’s remaining gift exclusion, and generally, GST exemption), the independent trustee enters into a purchase agreement with the grantor, most typically conveying a promissory note as consideration. As a general rule of thumb, the trust should have capital of at least 10 percent of the total purchase price fundamentally to forestall the negative gift and estate tax repercussions of a default on the note. Because the trust is disregarded for income tax purposes, the sale of assets by the grantor to the trust (the “purchasing trust”) is also disregarded for income tax purposes. Thus, income taxable gain or loss and interest income and expense with respect to the note are avoided; but, the grantor’s basis in the assets will also carry over to the purchasing trust.

The interest rate on the note must be at least equal to the applicable federal rate (AFR) prescribed monthly by the IRS. For example, a note with a three- to nine-year term would utilize the midterm AFR, which is currently 2.57 percent for transactions occurring in March 2018.
Wealth transfer planning alternatives

Transfers through leverage: The sale to a grantor trust

The tax consequences described above, however, assume that the grantor survives to see the note fully paid. Since grantor trust status ends when a grantor dies, the death of the grantor prior to the payment of the note introduces a number of income tax complications, some of which have uncertain answers, including whether or not any built-in gain with respect to the purchased assets is subject to recognition.

Like a GRAT, this alternative is interest rate sensitive. Much of its success depends on the purchased property appreciating and/or generating income at a rate higher than the interest rate on the promissory note. Most importantly, though, is that prior to the sale, the mechanics of the required debt service must be forecast. If the note cannot be paid without foreclosure on the sold assets, the bona fide of the transaction will be questioned. Consequently, cash flow is a more important consideration with this alternative than it is for a GRAT, which generally precludes the use of this alternative to transfer C corporation stock. This cash flow consideration generally makes this alternative more effective when using equity interests in pass-through entities (such as S corporations, LLCs, and partnerships) because of the tax distributions to which the pass-through owners are generally entitled.

Unlike a GRAT, a sale transaction is not subject to: (1) mortality risk (other than the complications arising if the note is not paid prior to the death of the grantor), (2) highly structured payments (other than the annual payment of interest), and (3) the related volatility risk. However, a sale always carries a valuation risk—that the purchase price is determined to be less than fair market value. If such an outcome prevails, the spread between the sales price and the fair market value of the purchased property, absent mitigation (discussed later), is considered a taxable gift, which will absorb the grantor’s exclusion amount (and GST exemption, if applicable) or even give rise to a gift tax payable.
Wealth transfer planning alternatives

Transfers through leverage: The sale to a grantor trust

Sale to grantor trust example
Ralph is the owner of a successful company, an S corporation, and wishes to transition ownership of his business to a dynasty trust to benefit his immediate family and future generations. Ralph forms and funds a specific form of grantor trust with $10 million of cash, utilizing some of his gift and GST tax exemptions. Ralph names his long-time adviser, Barbara, as trustee.

At a later date, Barbara, as trustee, agrees to purchase $100 million of company stock from Ralph. The purchase is financed through a promissory note with a nine-year term, with equal annual payments of interest and principal. The interest rate on the note is 2.57 percent, utilizing the midterm AFR for the month of the sale. The sale is disregarded for income tax purposes.

Over the nine-year term of the note, company sales and net income soar. The company makes tax distributions to its shareholders. Barbara, as trustee, utilizes this cash and, where prudent, the seed money, to make the required annual payments on the note and even some prepayments. The grantor used these funds to pay his income tax liability related to the income of the S corporation. After the note obligation is paid in full, the remaining assets of the trust will include all of the purchased company interest.

The result: Ralph leveraged $10 million of his gift and GST tax exemption to transfer $100 million of the S corporation through a transaction disregarded for income tax. Furthermore, because the note payments were utilized to pay income taxes related to the grantor trust’s assets, Ralph's estate was actually reduced by $110 million (the $10 million seed plus the $100 million face value of the note), excluding the post-sale appreciation on the company interest.

Sale to grantor trust

1. Grantor funds special grantor trust with seed capital (allocate GST exemption)
2. At a later date, the trustee may purchase additional property from the grantor in exchange for a new promissory note
3. Trustee makes required payments of principal and interest on the note to grantor
4. Beneficiaries will be under debt service constraints on their discretionary interests in the trust assets until the promissory note(s) have been satisfied
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Transfers through leverage: The sale to a grantor trust

Sale to grantor trust select benefits and risks

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<tr>
<th>Select benefits</th>
<th>Select risks</th>
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<tbody>
<tr>
<td>Disregarded sale – The sale (and interest on the note) is disregarded for income tax purposes, at least until the death of the grantor.</td>
<td>Control – The grantor cannot be the trustee nor retain control over the property in trust.</td>
</tr>
<tr>
<td>GST planning – Suitable for multigenerational wealth transfers (for example, transfers to both children, grandchildren and great-grandchildren).</td>
<td>Cash flow – The grantor must be willing and able to pay the trust’s income taxes throughout its term even if insufficient cash is received through the note payments.</td>
</tr>
<tr>
<td>Tax-free growth – Property in trust grows income-tax-free because the trust is structured as a grantor trust.</td>
<td>Risk profile – A bargain sale valuation risk (subject to mitigation) is always present.</td>
</tr>
<tr>
<td>Flexibility – Compared to a GRAT, there is more flexibility in making principal payments (if a balloon note is utilized).</td>
<td>Carryover basis – Property in trust receives carryover tax basis.</td>
</tr>
<tr>
<td>Lower mortality risk – Unlike the GRAT, the grantor does not need to outlive the note term to realize wealth transfer benefits; however, the collection of the note becomes more complex if it remains outstanding at death and the bona fides of the transaction may be open to greater scrutiny.</td>
<td>Market and downside risk – If trust property doesn’t perform and the note cannot be paid, the grantor has likely wasted some gift (and GST) exemption and the property is returned to the grantor.</td>
</tr>
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Wealth transfer planning alternatives

Leveraged transfers of actuarial interests: The RPM trust

Combining two alternatives
The remainder purchase marital (RPM) trust requires a married couple and, conceptually, combines the mechanics of a GRAT and the leverage of a sale transaction. At the outset, the grantor contributes property to a grantor trust (structured in the same manner as the trust discussed above). In its most common iteration, the trust conveys an annuity for the lesser of a term of years or life to the grantor’s spouse. This element of the structure behaves very much like a GRAT. Simultaneously, a family member or a trust purchases the remainder interest from the grantor. The purchasing trust is often structured as a dynasty trust.

The structure of the RPM trust transaction is intended to avoid a taxable gift by having (1) the spouse’s annuity interest qualify for the gift tax marital deduction, and (2) the grantor receiving full and adequate consideration from the purchaser of the remainder interest. The grantor retains no interest in the trust (thus eliminating the mortality risk inherent in a GRAT), but does take back an asset (the consideration for the purchase of the remainder interest). The amount of that consideration is determined by subtracting the value of the annuity interest from the net value of the assets contributed to the trust, to arrive at the value of the remainder interest. Where the RPM trust transaction differs from that of a Walton GRAT is that here, the remainder value should not be insubstantial (for example, several percent of the value of property contributed to the trust), thus encouraging robust oversight by the remainder beneficiary.

Whether an annuity interest is for a term of years, or the lesser of life or a term of years is a function of the spouse’s health. A term of years, or the lesser of life or a term of years, is used in order to provide certainty as to when the trust’s income or annuity payments will end. Subjecting a sum certain annuity for a term to the spouse’s life expectancy reduces its value (thus increasing the value of the remainder interest), but terminates upon the death of the spouse. If a term-of-years interest is used, the spouse’s estate will continue to collect any outstanding payments until the term expires.

While the actuarial factors above may affect the ultimate performance of the RPM transaction, its effectiveness is anchored in whether and the extent to which trust appreciation and/or income generation outpaces the imposed discount rate—since it is the discount rate that is used to compute the value of the annuity interest. If it fails to do so, like a GRAT, the trust will erode or “cannibalize” from the annuity payments to the spouse (although this risk does not arise with an income interest). Any trust assets left after the termination of the spouse’s interest pass to the purchaser of the remainder interest.
Wealth transfer planning alternatives

Leveraged transfers of actuarial interests: The RPM trust

There are two significant risks associated with the RPM trust transaction. The first is proper valuation of the property contributed. A successful valuation contest by the IRS may lead to a determination that the remainder interest was not transferred for full and adequate consideration. If the IRS prevails on this point, the potential exists that the gift tax marital deduction will be lost and a corresponding taxable gift will result equal to the value of the trust property less the consideration received for the remainder interest. Therefore, it is important to consider contributing readily marketable property and/or considering the use of formula valuation clauses (discussed later) to consummate the sale transaction. The second risk is that the transaction cannot easily accommodate a future divorce of the spouses.

RPM trust example

Jack (grantor) contributes $20,000,000 of appreciated, marketable securities to an RPM trust when the prevailing discount rate was 2.6 percent. The trust was established for the benefit of his wife, Jill (spouse), age 62. After modeling the expected performance of the property and considering Jill's health, Jill was conveyed a 7.25 percent annuity interest ($1,450,000 annually) for the lesser of 20 years or life (an actuarial value of $18,482,860). Jack retained the remainder interest, which he simultaneously sold for $1,517,140 cash to a long-standing dynasty trust, which at the date of the sale, was a grantor trust to Jack.

Assume that Jill passes away at the end of year 12, at which time the RPM trust terminates in favor of the dynasty trust. Over the term of the RPM trust, Jill collected a total of $17,400,000 ($1,450,000 per year for 12 years), which she sprinkled among her children and grandchildren in annual exclusion gifts or gave away to charities, leaving just enough to utilize her unused applicable exclusion amount for estate tax purposes. Having undertaken the planning, at the end of the 12th year, Jack's estate is $37,191,146 less than it would have been had Jack done nothing (even after taking into account the $1,517,140 of sales proceeds).

Note that Jill received less than the actuarial value of her interest, $18,482,860, because she predeceased her actuarial life expectancy by several years. This actuarial difference benefits the dynasty trust, which also benefits from the appreciation in excess of the 2.6 percent discount rate (the discount rate used to determine the purchase price). The dynasty trust, growing at the discount rate, would be expected to have a value of $3,052,784 at the end of its 12th year.
Wealth transfer planning alternatives

Leveraged transfers of actuarial interests: The RPM trust

RPM trust illustrations

At inception

1a Grantor contributes property to RPM trust...

Grantor

Dynasty trust

Family members

Spouse

2 Dynasty trust makes required payments of principal and interest on the note (if any) to the grantor

Grantor

Spouse

RPM trust

2 RPM trust makes annuity or income payments to spouse under the terms of the document

2b ...and grantor’s spouse is conveyed an annuity or income interest for life, a term of years, or the lesser of life or a term of years.

Family members

Spouse

RPM trust

At end of the annuity or income interest term, any remaining assets pass to dynasty trust

1b ...simultaneously the dynasty trust purchases the RPM trust remainder interest from the grantor for cash or a note...

Grantor

RPM trust

Family members

Spouse

2017 tax reform provides opportunity

Concepts for consideration

Transfers through arbitrage: The use of preferred equity interests

Transfers of actuarial interests: The GRAT

Transfers through leverage: The sale to a grantor trust

Leveraged transfers of actuarial interests: The RPM trust

Supplemental planning concepts

Considerations for your path forward
Wealth transfer planning alternatives

Leveraged transfers of actuarial interests: The RPM trust

RPM trust structure selected benefits and risks

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<th>Select benefits</th>
<th>Select risks</th>
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<tbody>
<tr>
<td>Disregarded sale – The sale (and interest on the note), if the purchaser is a grantor trust, can be disregarded for income tax purposes.</td>
<td>Valuation – Proper valuation of the property contributed is paramount if adverse gift tax consequences are to be avoided.</td>
</tr>
<tr>
<td>GST planning – Suitable for multigenerational wealth transfers (for example, transfers to both children, grandchildren and great-grandchildren).</td>
<td>Control – The grantor cannot be the trustee nor retain control over the property in trust</td>
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<tr>
<td>Tax-free growth – Property in trust appreciates tax-free (because the trust is a grantor trust).</td>
<td>Cash flow – Grantor must be willing and able to pay the trust’s income taxes throughout its term, notwithstanding that the only consideration received is the purchase price of the remainder interest (and, perhaps, the distributions received by the spouse).</td>
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- Low downside risk – The alternative is structured not to give rise to a gift. However, it is subject to high valuation risk.

- Mortality risk – The grantor and spouse do not need to outlive the transaction term—however, for a life income interest, outliving one’s life expectancy will undermine the planning. Unless a term-of-years annuity interest is conveyed to the spouse, the only assets includible in the spouse’s estate will be the trust distributions actually collected. The grantor will have the proceeds of the remainder interest sale in his or her estate.

- Market risk – If trust property does not perform better than the prescribed discount rate, depending on the structure, all trust assets could be conveyed to the spouse. Similarly, the purchaser of the remainder interest could receive nothing, but the grantor would still retain the purchase price.

- Risk profile – Less common planning transaction, has a higher than average valuation risk. Presupposes a solid marriage.
Wealth transfer planning alternatives

Supplemental planning concepts

The net gift (and bargain sale) concept

A net gift is a gift conditioned on the donee reimbursing the donor for (at a minimum) the related gift tax. It is called a net gift because the amount subject to tax is the net of (1) the value of the property transferred, less (2) the amount that the donee will reimburse the donor. With the new 2018 applicable exclusion amount of $11,180,000 per taxpayer—a net gift is helpful only with respect to very large transfers. However, because of its attributes, it can prove extraordinarily useful in the right circumstances.

The consideration in a net gift transaction need not be paid at any set point in time. If the donor is in a position to pay the tax with available liquid assets, the donee can agree to pay the bargain sales price through an installment note if circumstances require.

Because the net gift results in a bargain sale, the donor must consider whether there will be any income tax consequences arising from the transaction. If the donee is other than a grantor trust, taxable gain will result if the consideration received exceeds the donor’s tax basis. In addition, as is the case with all taxable gifts, the donor’s death within three years of the net gift will result in the gift tax being added back to the gross estate as a phantom asset, notwithstanding that the tax was reimbursed by the donee.

A net gift can be useful for significant transfers where there is an unwillingness on the donor’s part to bear the tax burden. It can also be used in situations where the asset being transferred is illiquid and the donee is better positioned to pay the related gift tax (as in the example below). When considering the renunciation of a marital trust by a surviving spouse, because of how the regulations approach the various steps of the transaction, a net gift will always result if the resulting gifts exceed the surviving spouse’s unused applicable exclusion amount.

Net gift example:

For ease of illustration we will assume a donor who has fully used her applicable exclusion amount agrees to transfer a highly illiquid asset to an existing irrevocable trust (for the benefit of her children) with a value of $14 million on condition that the trust reimburses her for the resulting gift tax. By virtue of this agreement, the trust would expend $4 million and the trust’s equity will have grown by the net amount of $10 million. The reimbursement of the gift tax of $4 million is treated as consideration for the transfer and thus, a bargain sale results—a sale of property having a value of $14 million for $4 million, resulting in a taxable net gift of $10 million.
Wealth transfer planning alternatives

Supplemental planning concepts

The use of formula valuation mitigation clauses

Valuation risk is inherent in any transfer of a hard-to-value asset—for example, an equity interest in a closely held business. Attempts to mitigate valuation risk have been relatively unsuccessful until recently. It now appears that formula valuation mitigation clauses can, if appropriately employed, provide that protection; although the IRS, despite its recent setbacks, continues to pursue the matter. There are three broad categories of valuation mitigation clauses:

A formula transfer clause operates by setting the value of the property transferred at a fixed amount. Thus, any upward adjustment in the value of the property gifted or sold is translated to a corresponding reduction in the quantum of property transferred and requires the parties to “true up” the economic consequences to correspond to those that would have existed had the finally determined quantum of property been known from the beginning.

A formula allocation clause fixes the quantum of property transferred, but also fixes the value of the property transferred to the primary donee. Thus, any adjustment in the value of the transferred property results in the primary donee transferring property having a value equal to the upward adjustment to a secondary donee. In order to avoid a deficiency in the gift tax arising from the increased value, the secondary donee is typically the donor’s spouse or a charity since such transfers can be made to qualify for the gift tax marital or charitable deductions. Thus, the taxable gift remains a sum certain.

A formula adjustment clause arises solely in a sale transaction and adjusts the purchase price to the value of the property transferred as ultimately determined, with corresponding provisions with respect to the interest due on the adjusted purchase price.
Wealth transfer planning alternatives
Supplemental planning concepts

The following example compares and contrasts the first two categories of formula clauses to illustrate possible results in a gifting situation:

**Facts:** Taxpayer intends to transfer a sum certain of $1 million of ABC Partnership units to DEF Trust. An independent appraisal values the units at $2,000/unit as of the date of transfer. Based upon this appraisal, taxpayer transfers 500 ABC Partnership units to DEF Trust. The IRS subsequently audits the gift tax return and a $2,500/unit value is sustained. Assuming the formula valuation mitigation clause is respected, following are the results under each approach:

<table>
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<th>Formula transfer clause approach</th>
<th>Formula allocation clause approach</th>
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<tr>
<td>“I hereby assign and transfer as a gift to DEF Trust a sufficient number of my units as a partner of ABC Partnership so that the fair market value of such units for federal gift tax purposes shall be $1,000,000.”*</td>
<td>“I hereby assign and transfer as a gift 500 units of ABC Partnership. I transfer to DEF Trust a fractional share of that 500 units, the numerator of which is $1,000,000, and the denominator of which is the value of such property as finally determined for federal gift tax purposes, and I allocate the remaining units, if any, to GHI Charity.”*</td>
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**Result:** Taxpayer has transferred a sum certain of $1,000,000 of units to DEF Trust. Upon revaluation, taxpayer was determined to have transferred 400 units (400 units x $2,500/unit = $1,000,000) to DEF Trust. Thus, of the 500 units to which DEF had originally taken title, 100 units were held in constructive trust (including any distributions related to those 100 units) for the grantor. No incremental gift tax is assessed as taxpayer’s transfer was defined as the number of units that would equal the sum certain of $1,000,000.

**Result:** Initially, taxpayer had transferred 500 units to DEF Trust. Upon revaluation, taxpayer was determined to have transferred 400 units to DEF Trust and 100 units to GHI Charity. Thus, taxpayer transferred the sum certain of $1,000,000 to DEF Trust (400 units at $2,500/unit) and $250,000 (100 units at $2,500/unit) to GHI Charity. The transfer of 100 units to GHI Charity qualifies for the gift tax charitable deduction, thus leaving the taxable gift at the original $1,000,000 and resulting in no incremental gift tax.

* It is important to note that because the IRS continues to contest the effectiveness of formula valuation mitigation clauses, how they are drafted in documents should not deviate from those forms that have been accepted by the courts. You should consult your attorney (in conjunction with your tax adviser) about specific language to be utilized.

In addition to having an effective formula clause, there must also be a “mechanism outside of the IRS audit (that) exists to ensure accurate valuation reporting.” In other words, not only must there be a qualified appraisal at the outset, but mechanisms must be in place to properly and expeditiously adjust the transaction as necessary if an adjustment in the value of the property prevails.

This includes, among others, proper titling of the property, trueing up equity distributions over the duration of the valuation controversy, adjusting promissory notes and interest obligations, updating records, and amending tax returns (unless a grantor trust is involved in the transaction) to reallocate income and loss, if necessary.
We hope that this chapter has provided you with a helpful overview of certain wealth transfer planning alternatives that wealthy families are employing today, depending on their goals and circumstances. Having read this release, you may have noted that these alternatives have a common theme—transferring wealth in a tax-efficient manner. However, each alternative has unique characteristics, benefits, and risks that may have greater or lesser importance to you given your goals and circumstances. Consider your planning objectives, your balance sheet, your risk tolerance, and your family dynamics in order to explore appropriate wealth transfer planning alternatives. And remember, don’t walk this path alone—your wealth advisers should assist you through the planning process. Enjoy the journey.