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A. ESTATE PLANNING STRATEGIES AND TACTICS

There are three basic objectives of estate planning that can be furthered by the use of entities.

1. Directing the Transfer of the Assets
   a. An entity holding assets facilitates the transfer of property.
      (i) The transfer of assets is simpler.
      - Transfer requires the use of a single instrument (stock or partnership certificate) rather than a variety of instruments and documents dictated by the type of property involved (deed, certificate of title, re-issuance of certificate or restatement of account).
      - A single transfer can cover a number of assets and kinds of assets held in a bundle by the entity.

      (ii) The transfer will not require the involvement of third parties such as a transfer agent, stockbroker or even an attorney, which could cause delay, cost and risk of error.
      (iii) There is no public disclosure of the transaction because it is not necessary to record the transfer instrument as it is with a deed to real estate.
      (iv) The transfer can be accomplished quickly; the transferor can prepare a certificate in a matter of minutes.
      (v) The transfer can be accomplished surely; the transfer is entirely within the transferor's control. The only risks, and they are major ones, are that the transferor doesn't properly prepare the certificate or accurately calculate the amount of the interest to be transferred.

   b. An entity holding assets facilitates the management and administration of the assets.
      (i) If the assets are held by a single entity rather than by multiple persons in undivided interests, their control is clearer and more centralized. This is particularly true if the asset is a closely held enterprise. Economies of scale may be possible.
      (ii) If the assets are held by a single entity rather than in undivided interests, their investment is coordinated.
      (iii) If the assets are held by a single entity rather than in undivided interests, title is simpler.

   c. Transferring assets to an entity creates an opportunity to review title to Probate and Non-Probate Assets.
      (i) In planning the transfer of assets to an entity it is necessary to identify the assets and titleholder and to distinguish probate and non-probate assets. This should eliminate surprises and permit coordination in the designation of beneficiaries between the probate and non-probate assets and planning for a liquid estate. Be especially alert for accounts designated, "joint tenants with right of survivorship". Banks and brokerage houses commonly recommend and prepare this form of ownership when accounts are opened. It can cause problems because the decedent's interest terminates at death, rendering the account solely to the survivor and providing nothing to fund other transfers or pay taxes.
      (ii) Some assets may need special treatment.
      - Out-of-state real estate may need to be transferred to a trust in order to avoid ancillary administration if the expected cost and delay justify it.
      - Designation of beneficiaries to IRA's and life insurance should be

reviewed to maximize tax advantages and avoid problems.

2. Minimizing the Cost, Delay and Risk of Transfer
   a. If an asset has already been transferred to a trust or other entity the transferor is more assured of the desired result. After the transferor's death there are a number of events that could de-rail the transferor's intent as expressed in a will, such as a will contest, uncertainty of interpretation, change in the law and failure in documentation.
   b. While a Durable Power of Attorney is not an entity it is a very useful transfer of authority. A Durable Power of Attorney permits the implementation or performance of an estate plan in case of mental disability. It is important to include in the durable power of attorney the specific authority to make gifts. Be aware that a power of attorney can be abused by the agent and that many institutions are loath to accept them.
   c. Transferring assets out of the estate will protect them from the claims of future creditors and assure their availability. Transferring assets out of the estate will not protect them from the claims of present creditors so long as those creditors' claims are unpaid. Uniform Fraudulent Transfer Act. (Texas Business & Commerce Code, Chapter 24)
   d. As already noted, out of state real estate may require an ancillary administration in the state where it is located adding difficulty, cost and delay to the administration of the estate. Transferring these assets to an entity, usually a revocable trust, will avoid these possible problems.
3. Minimizing Transfer Taxes (Estate Tax, Inheritance Tax and Generation Skipping Transfer Tax)
   a. One tactic for minimizing transfer taxes is to shrink the estate.
      (i) The amount of transfer tax is directly related to the value of the property transferred. The smaller the estate the less the tax. Therefore, transferring assets out of the estate will lower the prospective transfer tax liability. Estate and gift taxes apply to transfers for less than full consideration of any right or interest protected at law and having an exchangeable value. Generation Skipping Transfer taxes apply to transfers between persons (and their spouses) who are lineal descendants of the same grandparent and who are two or more generations apart.
      (ii) Estate and gift taxes are cumulative because of the unified tax scheme. Therefore, the only value that will truly escape gift and estate tax consequences are non taxable gifts (annual exclusion gifts - IRC Section 2503(b) and medical/educational payment gifts - IRC Section 2503(e)) and the future benefits generated by the transferred assets if the transfer did not occur (growth, interest, dividends, etc.). Transfers within the **Applicable Exclusion Amount**, $675,000 in 2000 and 2001, escape tax but consume the exclusion amount. Nevertheless, taxable gifts can be advantageous. First, the income and transfer taxes on all benefits accruing after the gift are borne by the donee. Second, the gift tax is tax exclusive. This means that the amount of the tax is computed on the amount of the property transferred and the donor pays the tax from the remainder of the estate, leaving the amount received by the donee unaffected. The estate tax is tax inclusive, which means that the amount of the tax is computed on the amount of the property transferred and the tax is paid from the property transferred, thereby reducing the amount received by the beneficiaries. Therefore, the effective tax rate is higher

for a death time transfer than for a lifetime transfer. Also, because the donor pays the gift tax there is the further benefit that the payment removes even more assets from the donor's estate.

(iii) The GST tax has different rules for assessment, exemption and exclusion. See Chapter 13, IRC.
- The exemption amount is $1M.
- With certain limitations the same non-taxable gifts are excludable.
- There are three classes of GST transfers. A **Taxable Termination** is basically a termination of an interest in property held in trust, which immediately benefits a Skip Person. A **Taxable Distribution** is a distribution from a trust to a Skip Person. A **Direct Skip** is a transfer to a Skip Person. A Skip Person is a person two or more generations below the transferor. The GST tax due as a result of a Direct Skip is assessed to the transferor. The GST tax due as a result of a Taxable Termination, Taxable Distribution and Direct Skip from a Trust is assessed to the Trust. Therefore, as in the case of a gift, a Direct Skip transfer is tax exclusive and comes out of the prospective estate and therefore it is preferable to the other transfers, which come out of the property transferred.

b. A second tactic for minimizing transfer taxes is to shrink the value of the assets.

(i) The Internal Revenue Code uses a willing buyer-willing seller analysis to value assets. When assets are transferred to an entity in exchange for an interest in the entity, the nature of the ownership interest fundamentally changes and, in fact, becomes a different property right. The ownership changes from direct to indirect and it becomes subject to restrictions at law and in contract. This change generally results in certain discounts from the gross value of the assets transferred because the indirect interest is not as attractive to a prospective buyer so it is not as valuable to the owner. The more the restrictions on the exercise of control or use of benefits of ownership, the greater the discount.
- **Minority Interest Discount**. This is also called a lack of control discount. It reflects the fact that the owner does not control the entity so he cannot direct the enjoyment of benefits from his ownership including forcing a partition or sale of his interest. The minority interest discount is generally between 20% and 30%, no matter what the size of the minority interest.
- **Fractional Interest Discount**. This is substantially the same as the minority interest discount with the addition that the owner can force a partition or sale. As a result the discount is not as great as with a minority interest.
- **Lack of Marketability Discount**. This reflects that the market places a higher value on liquidity.
- **Capital Gains Discount**. This reflects the intrinsic tax liability for an entity holding highly appreciated assets.

But there are also some premiums.
- **Swing Stock Premium**. This reflects the ability of the owner to join with another owner to exercise control of the benefits of ownership.
- **Control Premium**. This reflects the ability of the owner to control the benefits of the ownership. The premium is about 20%.

(ii) Corporate shareholder interest versus a limited partnership interest. A

minority shareholder generally has greater rights (right to participate and right to information) than a limited partner has so the discount is less.

(iii) General partnership interest versus limited partnership interest. A general partner can force liquidation; a limited partner generally cannot. The transferee of a limited partner has only the rights of an assignee, which is the right to receive distributions, if there are any. A transferee has no right to information or to participate. Therefore, the discount for a limited partnership interest is greater than that for a general partnership interest.

(iv) Liquidation value versus "going concern" value. An entity, which merely holds and invests assets, will be given liquidation value. An entity, which is operating, will be given "going concern" value.

c. A third tactic for minimizing transfer taxes to defer payment of the taxes.

(i) Delay realization of tax liability by using tax favored retirement plans no matter what the entity.

(ii) Avoid payment of GST taxes by skipping multiple generations.

(iii) Delay payment of tax on withdrawal from an IRA by designation of beneficiaries. Appoint a member of a younger generation as a co-beneficiary of an IRA or designate a trust as the beneficiary.

(iv) A Disclaimer Trust and a Qualified Terminable Interest Trust provide an opportunity to elect at the time of the death of the first to die of whether to pay transfer taxes then in the decedent's estate or later in the survivor's estate.

(v) The Internal Revenue Code provides for extensions of time for payment of estate taxes. IRC 6161 and 6166.

B. UTILIZING AN EXISTING ENTITY.

1. Transferring Assets to an Existing Entity.

a. There are advantages in that the existing entity has an established management and, presumably, an operating history.

b. There are disadvantages if there are other interest holders in the entity who are not intended beneficiaries or if the entity is not free of liabilities.

c. A transfer of assets to an existing corporation or partnership is a contribution to capital, which may trigger Chapter 14 issues.

2. Transferring an Interest in the Entity.

a. A beneficiary acquires an interest in a corporation or partnership by certificate transferred by the transferor.

b. A beneficiary acquires an interest in a trust by being named as the recipient of an interest in the trust instrument. Trust instruments generally prescribe the conditions under which beneficiaries and benefits can be changed. There are consequences to a transferor retaining the right to make those changes; principally, the trust becomes a Grantor Trust.

3. Recapitalizing an Existing Entity.

a. The ownership structure of a partnership or corporation can be restructured by creating additional classes of partners or shareholders. Historically, the restructuring has been to create a class with a liquidation preference to be retained by the transferor, allowing him to transfer the common stock which benefits from the future growth.

b. The ownership structure can also be restructured to create an additional class of partners or shareholders without control rights. This allows the transfer of interests without the risk of losing control.

C. STARTING FROM SCRATCH.

Certain very well defined situations utilize specialized entities.

1. Bypass Trust
   a. The overwhelming majority of people have estates that are small enough to be protected from transfer taxes by the Applicable Exclusion Amount ($675,000 in 2001, $1,000,000 in 2002) and the GST exemption ($1,000,000). A problem arises with a married couple whose individual estates are under the exclusion and exemption amounts but whose combined estate is in excess of those amounts. The problem arises when a couple devises to each other the entirety of their estate. They do this generally, out of a feeling of shared success and a desire to provide for the survivor. Unfortunately, in doing so they lose the benefit of the decedent's Applicable Exclusion Amount and the combined estate now held by the survivor may be large enough to be taxable.
   b. The solution is to include in the couple's wills or revocable trust a **Bypass Trust** to which is transferred an amount equivalent to the unused Allocable Exclusion Amount. The survivor can be the trustee and the life beneficiary with access to both the income and principal, as needed. The assets in the trust will not be included in the survivor's estate and perhaps make it taxable but will "by pass" the survivor's estate. At the death of the survivor they will pass as directed in the Trust to the couples' beneficiaries. Thus the survivor is provided for and transfer taxes are avoided. It can also be called a **Credit Shelter Trust** because it shelters the Applicable Exclusion Amount which is the equivalent of the credit of the first spouse to die.
2. QTIP/QDOT Trust
   a. The Internal Revenue Code provides a deduction from an estate for property transferred from one spouse to another. This is called the Marital Deduction. The effect is to allow the transfer of assets between a married couple to be transfer tax-free. Therefore, the transfer of the decedent's estate to the survivor results in no transfer tax in the decedent's estate. But, such a transfer has two drawbacks. The first is that the property transferred increases the surviving spouse's estate perhaps making it taxable. The second is that it gives the surviving spouse control over the disposition of the entire estate in a new or amended will.
   b. One tax planning tactic to overcome these drawbacks is to transfer the decedent's interest to a trust for the survivor's benefit and have the trust terminate at the survivor's death. The decedent's interest would not be part of the survivor's estate and the interest would pass as decedent directed in the trust. But this had the effect of avoiding transfer tax in both spouses' estates, a result that Congress corrected with a special rule called the Terminable Interest Rule. That rule was that the marital deduction is denied in this situation, keeping the value of the interest in the decedent's estate for the calculation of the estate tax.
   c. But, this structure was very useful in estate planning for allowing the decedent to provide for the surviving spouse and still control the transfer of the trust assets. This is the case where a person is in a second marriage, wants the survivor to benefit from the assets, but wants the assets to go to the person's own children when the survivor dies. In response Congress created an exception to the Terminable Interest Rule for Qualified Terminable Interest Property (QTIP) in IRC Section 2056(b)(7). Election of the exception allows

the Marital Deduction for property transferred to the terminable trust even though under the Terminable Interest Rule it wouldn't be.
Under the statute the executor of the decedent's estate makes the election and the election can be made as to all, none or part, including as a percentage. This gives flexibility and an opportunity to assess the survivor's needs and the relative impact of inclusion in the spouse's estate versus the survivor's estate. The property not elected remains in trust but its value is not deducted from the decedent's estate. The property elected remains in trust and its value is deducted from the decedent's estate has a marital deduction is treated as part of the survivor's estate and is subject the certain limitations specified in the statute. Because of this combination of benefits, the wills or revocable trust for a married couple, especially those in a second marriage, typically include a QTIP trust to which is transferred the assets the spouse desires to control the transfer of after the death of the survivor.

d. The marital deduction is also denied for any assets passing to a non-United States citizen, surviving spouse. The reason is the concern that the survivor will move back to his/her native country and take the assets beyond the reach of United States transfer taxes. The solution is another trust called a Qualified Domestic Trust (QDOT). Property transferred to a QDOT is eligible for the marital deduction if elected by the executor of the decedent's estate. IRC Sections 2056(d) and 2056A.

3. Family Limited Partnership
   a. Family Limited Partnerships are a popular estate-planning tool because they combine several of the desirable benefits with flexibility. The benefits are aiding the transfer, management and investment, allowing the transferor to maintain control and income, if desired, and minimizing the transfer taxes by getting the assets out of the estate and obtaining discounts.
   b. Typically, the transferor and spouse, who are senior family members, transfer assets to a limited partnership in exchange for a small (1%) general partnership interest and the remainder limited partnership interest (99%). This largely separates control from equity. The transferor and spouse can then make gifts of limited partnership interests to junior family members over time thereby divesting themselves of equity without losing control of either the partnership or the assets transferred. The general partnership interest can be held by a trust, corporation or limited liability company controlled by the transferor. One reason to have an entity hold the general partnership interest is that if the general partner dies, the partnership dissolves which has adverse tax consequences.
   c. Limited partners cannot participate in management and have no exposure to partnership liabilities.
   d. If a limited partnership interest is transferred or seized by a creditor, unless the other partners agree, the transferee will only have the rights of an assignee. Although the assignee cannot require a distribution of partnership profits, it will be required to pay income tax on its pro rata share of any income received by the partnership.
   e. The transferred limited partnership interests are minority interests without control or marketability so as gifts they will be entitled to a steep discount.
   f. The retained limited partnership interests may also be without control and marketability so as assets in a decedent's estate they will be entitled to a steep discount. Although the general partnership interest holds control, it lacks marketability and has a very small value.

g. Presumably the transferor is in a higher income tax bracket than the transferees. Therefore, the income allocated to the transferees will be taxed at a lower rate.
h. The partnership can hold out-of-state real estate, avoiding an ancillary administration.
i. The partnership agreement can be modified as needed.
j. The transferor can be paid for management services from partnership income.
k. Instead of being parceled out among beneficiaries, the partnership interest can be transferred to a trust, which can distribute the income according to its terms. If there are no family members interested or capable of succeeding to management of the business, the trust can hold and ultimately sell the partnership assets/business when the senior family members die or are no longer able or willing to conduct the business.
l. There are a huge number of traps and IRS scrutiny, if not challenge, is guaranteed.

4. Life Insurance Trust
   a. An irrevocable life insurance trust is a vehicle to avoid the surge in value which occurs to the owner of life insurance when the subject dies. It is useful to provide liquidity to the transferor's estate, for example for the payment of transfer taxes. The liquidity can be used either as a loan or as cash to purchase assets.
   b. Typically, the transferor creates an irrevocable trust and makes a gift to the trust of income producing assets or cash which it can use to purchase life insurance on the life of the transferor, or make annual premium payments on the insurance. When the transferor dies, the proceeds are not part of his estate.
   c. There are a number of traps including the inflexibility of irrevocable trusts, transfer for value rules, handling the annual gifts for payment of the premiums (Crummey Powers), the transferor as trustee and the terms by which the proceeds are use to pay transfer taxes.
   d. A Family Limited Partnership is a good vehicle to own life insurance because it avoids some of the Crummey Power problems but if life insurance is the only asset there are other problems.
5. Sale of Family Business
   a. The handling of the sale of a family business is one of the areas where an estate planner or tax advisor can have the most impact. There are a wide range of avenues by which the tax impact on the sale of a business can be mitigated such as installment note sale, private annuity sale, self-canceling installment note sale, grantor retained annuity trust (GRAT), qualified personal residence trust (QPRT) (for a home) and deferred payment sale to a Grantor Trust.
   b. The transferor typically has an opportunity or desire to sell the family business and, given the circumstances of age and proximity to retirement, he needs to do some estate planning at the same time.
   c. The planning needs to begin before the search for a buyer begins.
6. Making Charitable Gifts
   a. Some clients will want to make charitable gifts or bequests. Because such transfers are tax deductible, the discounts made available through a partnership or corporation are not as attractive to a transferor. Minority and unmarketable interests will not be very attractive to charities.
   b. Some assets are better given to charities than to others. A charity won't pay

income tax on the capital gain upon the sale of a highly appreciated asset given to it. A child will receive the same gift with the donor's basis and pay income tax on any appreciation when it is sold.

c. Some clients will want to make gifts or bequests to a charity and create an interim life estate or income interest in themselves, in some other beneficiary, or in a sequence of beneficiaries. This can be accomplished through a Charitable Remainder Trust – Charitable Remainder Annuity Trust (CRUT) or Charitable Remainder Unitrust (CRUT) - and Charitable Gift Annuities. In a Charitable Remainder Trust property is transferred to a trust with a retained life estate or income interest to a beneficiary for life and the remainder to the charity. A Charitable Gift Annuity is the transfer of money or property to a charity in return for the charity's commitment to pay designated annuitant's fixed payments for life.

d. Some clients will want to make gifts or bequests and still have something left for a beneficiary. This can be accomplished through a Charitable **Lead Trust** – Charitable Lead Annuity Trust (CLAT) and Charitable Lead Unitrust (CLUT). The transferor transfers property to a trust, granting a charity the income interest for a period of time with the remainder to a beneficiary or a reversion to himself.

e. Some clients will want to make a gift of specific property but be able to continue to use the property. This can be accomplished by transferring the property to the charity and retaining a life estate. No entity is needed.

D. FINDING THE RIGHT FIT.

While there are formats and templates which can be generally followed for innumerable situations, there are so many variables in any family situation, particularly the desires of the client, and the law is so complex, often turning on the subtlest of facts or drafting, that the development of an estate plan is necessarily unique. Once the facts and intentions of the client are known, the documents must be drafted in anticipation of events and legal issues that could frustrate or deny the client's goals.

1. The Priorities of the Client
   a. Transfer Scheme
      (i) The client will have a clear idea of a general transfer scheme. This clear idea will become muddled as he is made aware of the consequences its implementation will have on other priorities.
      (ii) The clear idea will be further muddled by all of the contingencies and alternatives that have to be incorporated into the estate plan.
      (iii) The client's transfer scheme is usually on the top in the list of priorities. That is something within his knowledge and that he has thought about. A plan that provides for beneficiaries to receive an interest in an entity rather than an amount of cash or undivided interest in specific assets will not be either within his knowledge or something that he has thought about and will raise some very practical and emotional concerns.
   b. Minimize Transfer Taxes
      (i) An estate planner is usually focused on minimizing transfer taxes and is trained to use entities in doing so. Many clients are not familiar with entities. As a result the client will be torn between doing the smart thing and being comfortable with the plan.
      (ii) Minimizing transfer taxes will usually be tempered with a desire to maintain control of the assets and the income stream/use of the assets.

That desire can be accommodated.

(ii) Because of the comprehensiveness of the transfer tax scheme, there are limits on how much tax can be saved by transferring property. As a result there are trade-offs.

c. Maintain Use/Income Stream

The client may need to or desire to keep using the income from the property or the property itself. This can be accomplished using entities, particularly trusts.

d. Control of Assets

(i) Retention of too much control by the transferor may preclude a successful transfer. A gift must be complete; that is, beyond the control of the transferor. Where the separateness of the entity is ignored by the transferor, the IRS may allege that the entity is a sham and that the transfer should be ignored.

(ii) Nevertheless, control by the transferor after the transfer is something that can be accomplished.

e. Control of Future Transfers

(i) The client may want to control benefits far into the future. This can be accomplished with a trust but it often creates more problems than it solves.

(ii) Too long a suspension before vesting of title may violate the rule against perpetuities.

f. Minimize Income Taxes

(i) Minimizing income taxes is generally a second level objective. But the income tax consequences need to be calculated because it's possible to do something really stupid. Minimizing income taxes is accomplished simply as a result of the transfer assets to in entity with a lower marginal tax rate.

(ii) The client may want to make the transfer but continue to pay the income taxes.

(iii) Although the entity may be a Texas corporation, check the box regulations will allow the entity to choose to be taxed as a partnership.

2. The Circumstances of the Client.

a. The sophistication of the client and family need to be taken into account. The client may not understand an elaborate plan. If the client doesn't understand the plan, the decision approving the plan isn't really the client's. If something goes wrong with the plan, the lawyer may be blamed.

b. The health of the client needs to be considered. Some actions can be taken when the time of a client's death can be fairly well anticipated, such as gifts. Some actions taken when the time of a client's death can be fairly well anticipated are risky, such as creation of a family limited partnership or gift of minor interests in order to achieve a minority interest discount. (Gifts can be made even after incapacity if the client has executed a durable power of attorney that grants that authority.)

c. The likelihood of the client maintaining the plan is an ongoing concern. The client will have to implement the plan by transferring the assets and opening the accounts. The client will have to understand and observe the separate identity of the entities. In the case of an insurance trust, the client will have to make the annual crummy gifts.

d. The possibility of disruption of the family or business will be everyone's concern. Some situations are so tenuous that they may be best left alone.

Some situations are so tenuous that they must be dealt with now rather than later.

e. One of the major issues in any estate plan is the anticipated liquidity needs of the estate. There need to be some assets in the probate estate to be used to pay taxes. Wealth tied up in assets that pass outside of probate are still part of the taxable estate and will incur taxes.

E. ISSUES NOT TO BE FORGOTTEN

1. Chapter 14 special valuation rules
   a. Chapter 14 provides special valuation rules, which are exceptions in certain situations to the willing buyer-willing seller determination.
   b. Section 2701 deals with valuation of certain transfers of interests in corporations and partnerships.
   c. Section 2702 deals with valuation of transfers of trust interests (generally GRITS) and joint purchases.
   d. Section 2703 deals with valuation of property subject to buy-sell provisions.
   e. Section 2704 deals with valuation of discount partnerships, lapsing rights and liquidation restrictions.
   f. Chapter 14 is generally applicable to transactions involving family members which shift value.
2. After the Estate Plan is prepared make sure that it is properly and completely implemented.
   a. The documents have been signed and the exhibits were prepared and attached.
   b. The required entities were created.
   c. The assets were transferred to the entities.
   d. The interests in the entities were issued.
   e. The reminders are for the tax returns to be timely filed.
3. Loss of Step up in Basis

   An asset that is transferred to an entity won't receive a step up in basis when the transferor dies. If an asset is highly appreciated and the owner is very old or very ill, the better decision may be not to transfer it.
4. Fraudulent Transfer Act (Texas Business & Commerce Code Chapter 24)
   a. The client can transfer assets despite the existence of current liabilities, but don't expect to transfer the assets beyond the reach of existing creditors. The transferred assets will, however, be beyond the reach of future creditors.
   b. Instruct the client as to how to show the transfers or interests on a financial statement.
5. Grandfathered Rights

   Some rights are too valuable to be lost as a result of a transfer or amendment.
   a. Exclusion from the operation of Chapter 13, GST tax.
   b. Exclusion from the operation of Chapter 14, Special Valuation Rules.
6. Appraisals
   a. There will be a need for an appraisal in the event of a dispute with the IRS.
   b. An appraisal will substantiate the taxpayer's good faith and may thereby provide a safety net to avoid tax penalties.