

# Estate Planning With Disregarded Entities\*

**Richard A. Oshins**  
**Oshins & Associates, LLC**  
**1645 Village Center Circle**  
**Suite 170**  
**Las Vegas, NV 89134**  
**(702) 341-6000**  
[roshins@oshins.com](mailto:roshins@oshins.com)  
[www.oshins.com](http://www.oshins.com)

**Circular 230 Disclosure:** To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication, including attachments, was not written to be used and cannot be used for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein. If you would like a written opinion upon which you can rely for the purpose of avoiding penalties, please contact us.

**\*Copyright 2009 by Richard A. Oshins. All Rights Reserved.**

## ESTATE PLANNING WITH DISREGARDED ENTITIES\*

By  
Richard A. Oshins  
Oshins & Associates, LLC  
1645 Village Center Circle  
Suite 170  
Las Vegas, NV 89134  
(702) 341-6000  
[roshins@oshins.com](mailto:roshins@oshins.com)  
[www.oshins.com](http://www.oshins.com)

### I. INTRODUCTION

Despite a myriad of variations, sophisticated wealth shifting generally encompasses the interaction and blending of several important components – trusts, leverage strategies and the use of entities to obtain valuation discounts.

#### A. Entities

Typically, the preferred entities for leveraged wealth shifting are FLPs, LLCs and S Corporations.

#### B. Valuation Reduction Strategies

A critical element of moving wealth outside of the transfer tax system is the ability to obtain valuation discounts – i.e., “. . . passing on more value than meets the taxable eye in the transfer.” George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 Col. L. Rev. 161, 171 (March 1977).

#### C. Trusts

1. Dynastic
2. Income tax defective as to grantor (IRC §§ 671-677) or to beneficiary (IRC § 678)
3. Split-interest trusts, principally GRATs.

#### D. IDGTs and GRATs

Two of the principal and most popular wealth shifting techniques to disgorge existing wealth are:

---

\*Copyright © 2009, by Richard A. Oshins. All rights reserved. The author wishes to thank Kristen E. Simmons of Oshins and Associates, LLC for help on this outline.

1. Installment note sales to Income Tax Defective Grantor Trusts (“IDGTs”) - Non-controlling interests in entities are sold to an income tax defective trust in exchange for an installment note, generally interest only with a balloon payment; and
2. Grantor Retained Annuity Trusts (“GRATs”) – Assets are transferred to a trust in exchange for an annuity substantially equal in value to the transferred property.

#### **E. The Estate Planner’s Dream Scenario**

Under both techniques, it is desirable for the estate owner to:

1. Contribute discountable income-producing assets to the trust; and
2. Receive payment back in assets, such as cash, which are not discountable

## **II. ENHANCING THE WEALTH SHIFTING BY ADDING THE “DISREGARDED ENTITY” COMPONENT**

### **A. In addition to the three components listed above:**

1. Use of entities;
2. Valuation discounting; and
3. Trusts, particularly defective, dynastic trusts

We would like to use (where factually appropriate), entities which are “disregarded” for income tax purposes.

### **B. The use of disregarded entities is particularly useful for one or more of the following fact patterns:**

1. The asset being transferred has low cash flow or cash flow insufficient to pay
  - (a) The GRAT annuity; or
  - (b) The installment obligation

out of cash flow. The goal is to avoid “in-kind” payments to the grantor that would be subject to valuation discounts.

2. The client would like to magnify the wealth shift.
3. The entity has low basis assets that we would like to use in the wealth shifting process, but which we would like to receive back so that it will receive a step-up in basis at death.

### **III. ESTATE PLANNING WITH DISREGARDED ENTITIES COMBINES:**

**A. Income tax defective trusts;**

**B. A disregarded entity; and**

**C. The “estate planner’s dream” -**

1. Transferring discounted assets to a trust; and
2. Receiving back assets which are not subject to a valuation discount

### **IV. WHAT IS A “DISREGARDED ENTITY” FOR INCOME TAX PURPOSES**

**A. A single owner entity that has not elected to be classified as an association (corporation). IRC §7701; Treas. Reg §§301.7701-1(a); and 301.7701-2(c)(2)**

1. The existence of the entity is ignored
2. It is a “tax nothing”

**B. The “disregarded entity” concept is similar to the defective trust concept.** The existence of the entity is recognized for transfer tax and creditor purposes, but not recognized for income tax purposes. These characteristics are common to both income tax defective trusts and disregarded entities.

1. For income tax purposes the entity does not exist.
2. The entity existence is respected for
  - a. Transfer tax purposes
    - i. Estate, gift and GSTT
    - ii. Therefore, discounts are obtainable
  - b. Creditor protection purposes
    - i. State property law controls
    - ii. Therefore, benefits such as creditor protection, exist
3. The Service ruled in Rev. Rul. 2004-88 that although a disregarded entity is not recognized for federal income tax purposes, the entity exists under state law and state law controls the owner’s rights and economic interests.

**C. Rev. Rul. 2004-77 provides that an eligible entity with two owners under local law can be treated as a disregarded entity.**

1. In Rev. Rul. 2004-77, a partnership was owned by a corporation and an LLC wholly-owned by the corporation. Although they were partners under local law, because one of these partners, the LLC, was a disregarded entity

as to the other partner, the corporation was treated as owning the entire partnership for income tax purposes.

2. Other Examples

- a. Example – individual and a defective trust in a partnership
- b. Example – FLP which owns 100% of an LLC
- c. Example – FLP with LLC (if 100% of the LLC owned by an individual and the remaining partnership interests are owned by the same individual)

**D. The “check-the-box” regulations classification that the entity is disregarded will not prohibit the use of the “willing buyer/willing seller” valuation rules and the applicable Regs. for transfer tax purposes in a hypothetical transaction. *Pierre v. Comm’r.*, 133 T.C. No. 2 (Aug 24, 2009)**

1. The proper rule is that state law controls for determining what has been transferred in the valuation process. This rule has been recently wrongfully ignored in some recent cases where the IRS and courts have applied a “step transaction doctrine.”
2. “While we accept that the check-the-box regulations govern how a single-member LLC will be taxed for Federal tax purposes, i.e., as an association taxed as a corporation or as a disregarded entity, we do not agree that the check-the-box regulations apply to disregard the LLC in determining how a donor must be taxed under the Federal gift tax provisions on a transfer of an ownership interest in the LLC. ... To conclude that because an entity elected the classification rules set forth in the check-the-box regulations, the long established Federal gift tax valuation regime is overturned as to single-member LLCs would be ‘manifestly incompatible’ with the Federal estate and gift tax statutes as interpreted by the Supreme Court.” *Pierre v. Comm’r.* (Emphasis supplied)

**V. GRATs WITH DISREGARDED ENTITIES**

- A. The ideal GRAT structure is where the grantor transfers discountable, income-producing assets into the trust in exchange for an annuity which is paid from the cash flow generated by the gifted property (a closely held business generally fits that profile).**
- B. The annuity must be paid at least annually (Treas. Regs. § 25.2702-3).**
- C. If cash is unavailable, the payment would ordinarily be paid “in-kind” with a portion of the transferred asset.**

1. In such instance, the valuation discount must be applied to the in-kind payment, sharply reducing the effectiveness of the wealth shift.
2. A new, and often expensive, appraisal must be obtained.
3. Although GRATs are generally considered “safe” transactions from a valuation standpoint, that safety exists for the initial funding and not for the payment of the annuity. See Craig L. Janes, “Grantor Retained Annuity Trust: Avoiding the Petards in an Otherwise Safe Harbor,” Estate Planning May, 2006 for an outstanding article discussing some of the risks associated with the operation of GRATs, including the payment of the annuity.

**D. Use a graduated GRAT, increasing the annuity by 20% per annum.**

**E. If the cash flow is moderate relative to the value of the property, which often occurs with real estate (for example), one option is to expand the annuity term in the GRAT in order to pay the annuity in cash.**

1. Extending the term often results in a significant reduction in the annuity payments in the early years.
2. That reduction, particularly because it is applied to the discounted gift, is often sufficient to handle the annuity payments in the early years.
3. That option, however, extends the risk of estate tax inclusion on account of the failure of the grantor to survive the term, which might:
  - a. be a tolerable risk, or
  - b. be hedged by acquiring life insurance.
4. In many instances, even an extended term will not enable the annuity to be paid solely with cash flow for the entire term. The problem becomes more acute as time passes, since the annuity will continue to rise.
5. Often a time will come when the annuity can not be paid with existing and accumulated cash flow.

**F. Consider, as an illustration, a fact pattern that we encountered in our office several years ago where the client has several parcels of real estate with a 5% cash flow and a projected 5% annual appreciation. Assume each parcel is worth \$10 million. To simplify the mathematics, assume further our appraiser felt that a 40% valuation discount was appropriate and that the client has 3 children. At the time we did the transaction, the AFR was 5%. See Exhibit A for the structure.**

1. The client could create a single member LLC (our client created separate LLCs for each parcel because of the desire to limit liability) that would be taxed as a “disregarded entity” for income tax purposes, but the entity wrapper would be recognized for gift tax purposes.
2. The client would transfer non-controlling interests in the LLC to the GRATs.

- a. In our situation, the client transferred 1/3 of each LLC to each GRAT.
  - b. The client can retain the 1% controlling interest if desired.
3. The GRAT should be designed as a graduated GRAT with annuity payments increasing by 20% per annum as authorized by Treas. Reg. § 25.2702-3(b)(1)(ii)(A).
  - a. An increasing annuity will make it easier for the annuity payments to be paid with cash flow in the earlier years.
  - b. See Exhibit B which illustrates that with a level GRAT the cash flow is unable to fully fund the annuity, and Exhibit C which shows that with a graduated GRAT the annuities can be funded during the initial few years.
4. In the later years, when cash flow is insufficient to pay the annuity, the grantor can purchase assets from the disregarded entity (e.g., 100% of a parcel of realty) so that the disregarded entity has the cash to distribute to the GRATs to fund the annuity.
  - a. If the grantor purchased interests in the entity from the separate GRATs, the purchase price would be subject to a valuation discount.
  - b. By acquiring an asset from the entity itself, there would not be a discount since the entire asset (the parcel of real estate) would be purchased.
  - c. This enables us to achieve the preferred goal of discountable assets gifted to the GRAT and cash back in payment of the annuity.
  - d. Because the entity is a “disregarded entity” and the GRATs are “grantor” trusts, the sale is income tax-free.
  - e. In our case (the client with several parcels of real estate with a 5% cash flow), we placed one-third interests in three entities into three 10-year GRATs. If the economic projections are accurate, we will be able to acquire (without discount) one property from an LLC and the cash flow problem will be solved.

**G. Can a client do a GRAT/disregarded entity strategy with an investment partnership (or LLC) consisting of all or a substantial portion of publicly traded securities?**

1. Yes, provided that the advisor properly designs and implements the entity and the client follows proper procedures. See also, Stacy Eastland, *Defending the Family Limited Partnership – Estate of Elaine Smith White v. Comm. In the Tax Court*, CCH Financial and Estate Planning, ¶ 31,961. I had the privilege of presenting this concept with John Porter where his portion of the presentation substantially consisted of addressing the suitability of a discount in

this context. See also the recent case of *Pierre v. Comm'r*, 133 T.C. No. 2 (August 24, 2009).

2. There appears to be specific authorization in IRC § 761(a) for a partnership for investment purposes.

#### **H. The conventional planning with publicly traded stocks is to use single asset, two-year rolling GRATs.**

1. The virtue of this conventional planning is illustrated in Exhibit D.
2. However, conventional rolling GRATs do not:
  - a. Allow for funding with discountable assets;
  - b. Lock in present low interest rates;
  - c. Enable the grantor to fully exploit the very low early payment feature of a graduated GRAT;
  - d. Take advantage of the disregarded entity concept;
  - e. Lock in the strategy, protecting against a possible change in the law.
3. In many instances, a longer-term, graduated GRAT funded with non-controlling interests in a disregarded entity may be significantly superior to the conventional short-term rolling GRAT approach.

## **VI. IDGTs WITH DISREGARDED ENTITIES**

#### **A. Similar to a GRAT, an ideal IDGT structure involves a grantor transferring discountable, income-producing assets into the IDGT(s) in return for a note, payable for a period of time with interest only and a balloon payment of principal at the end of the term.**

1. The preferred plan is to pay the interest and balloon payment with cash or other assets that are not subject to a valuation discount.
2. The preferred plan is difficult to achieve with assets that produce little or no cash flow.

#### **B. Assume that the client (who has three children) owns some real estate, in a single member LLC with a 1.5% cash flow and a projected 5% appreciation. The real estate is worth \$10 million and our appraiser felt that a 40% valuation discount was appropriate.**

1. The client could contribute by gift \$300,000 of cash or cash equivalents to IDGTs for each of the client's three children and their descendants.
2. The client would then sell 1/3 of the LLC to each IDGT for a note paying interest only, plus a balloon payment of principal.
3. Each trust would have its \$300,000 seed money plus \$50,000 of current cash flow to pay the interest.

- a. The current cash flow in the entity is 1.5% of \$10 million or \$150,000.
- b. Thus, each trust will have available cash flow of \$50,000, if distributed, in addition to its available seed money.
- c. If the interest on the note is 4% per annum, annual interest payments of \$80,000 per trust are payable to the client (4% x \$2 million).

*Planning Note* – The installment interest is applied against the FMV of each interest transferred, (the discounted interest), while the cash flow is based on the proportionate ownership of the entity and is not discounted. In effect, the discount reduces the “hurdle” amount.

- d. There is projected cash flow shortage.
- e. The initial seed money and available annual cash flow can be used to pay the note.
- f. The seed money can be used to fund the cash flow short-fall.

**H. Because interest payments are expected to exceed cash flow and/or the balloon payment when it becomes due, and because there possibly will be other needs for the cash flow, such as building or repairs, we will be faced with the dilemma of insufficient cash or cash equivalents to pay the note payments.**

**I. One option is to make the payment “in-kind.”**

1. The payment in-kind would be income tax-free. See Rev. Rul. 85-13
2. Appropriate discounts would have to be taken for assets paid in-kind which would leak wealth from the trust and adversely affect the wealth transfer.

**J. At such time as the available cash in the IDGT is insufficient to pay its debt obligations (income or principal) the client can purchase the underlying asset from the entity (the LLC).**

1. By acquiring the asset from the LLC, the client would be acquiring the entire interest in the asset.
2. The acquisition of 100% interest in the asset from the LLC would avoid the discount, in effect, leaving the discount in the trusts plus the post-transfer appreciation.
3. Thus, both the post-transfer appreciation and the discount is shifted to the IDGT.

**K. There is no gain on the purchase of the asset from the LLC because**

1. The entity is “disregarded” and
2. Rev. Rul. 85-13 provides that the existence of the LLC is essentially ignored.

**VII. QUALIFIED PERSONAL RESIDENCE TRUSTS (“QPRTs”) AND ALTERNATIVE SOLUTIONS**

**A. QPRTs are popular estate planning vehicles.**

1. I believe they are significantly over-used.
2. Transferring interests in a “disregarded entity” holding a residence to GRATs and/or IDGTs appears to be superior to QPRTs.

**B. What is a QPRT?**

1. The grantor transfers his residence (preferably an undivided interest in the residence to separate QPRTs so as to obtain valuation discounts) to a qualified trust.
2. The grantor retains two rights:
  - a. The right to use and occupy the residence for a specified term, and
  - b. A contingent reversionary interest if the grantor dies during the term.
3. Both retained interests, the term use and the contingent reversionary interest, are capable of valuation, and reduce the gift to the QPRT.
4. If the grantor survives the term, the residence will pass to the remainder beneficiary without a further gift.
5. If the grantor does not survive the term, the residence will be included in the grantor’s estate.

**C. Primary negative features of QPRTs which can be mitigated or eliminated using the QPRT alternatives:**

1. Mortality risk;
2. Large gift;
3. Prohibition against reacquisition (See Treas. Reg. § 25.2702-5(c)(9)); and
  - a. To live in after the term.
  - b. To obtain step-up in basis at death.
4. Complex rigid regulatory requirements.

**D. Alternatives – House GRAT and/or House IDGT using “Disregarded Entity.”**

Steps

1. Client places residence into a disregarded entity such as an LLC.
2. Client transfers non-controlling interests in the LLC to GRATs, IDGTs or a combination.
3. In order to continue to live in the residence, client must pay fair market rent to the entity. The rental will vary depending upon the location of, the size of and the current market for the residence.
4. Payments of rent to the LLC can be distributed pro rata to the members of the LLC and can fund:
  - a. The annuity for a GRAT; and/or
  - b. The interest payments for a note sale to an IDGT. The interest payments, plus the “seed” money will be available to pay interest on the note.
5. At such time as the available cash can not pay the annuity, or note, the client can acquire the residence from the entity for the then FMV of the residence.
  - a. Such action would leave in the GRAT or IDGT both the appreciation of the residence and the discount applied at the initial transfer.
  - b. The disregarded entity enables the client to “reacquire” the residence, an impermissible act in a QPRT
    1. To own and use the residence rent-free.
    2. To obtain a basis step-up at death.

**E. Comparative Illustrations**

1. Assume a 60-year old client owns a residence worth \$2 million; a reasonable discount would be 30% (note that a non-controlling interest in an LLC, or similar entity, owning a residence would generally receive a larger discount than a fractional interest would receive); fair annual rental is 3%; anticipated growth is 2% and the AFR is 3.4%.
2. Exhibit E is a QPRT
  - a. Gift is \$599,172.00.
  - b. Client must survive the term of 15 years.
  - c. No right to reacquire.
  - d. ETIP rule precludes generation-skipping trust.
3. Exhibit F is a House GRAT
  - a. Gift is \$5.01.
  - b. Client must survive the term of 15 years.
  - c. Right to reacquire.
  - d. ETIP rule precludes generation-skipping trust.
4. Exhibit G is a House IDGT

- a. Gift of \$160,000.00 is made, however, income tax-free growth is shifted from estate.
- b. No survivorship requirement.
- c. Right to acquire.
- d. Can generation skip.
- e. Discount is locked in.

## **VIII. QPRTs v. GRATs**

### **A. Unified Credit Used**

1. QPRTs can use substantial amounts of unified credit.
2. GRATs can be structured to use an insignificant amount of unified credit.  
✓ GRATs win

### **B. Term-risk of Inclusion**

1. In order to reduce the gift attributable to a QPRT, a longer term must be used, which increases the risk of the grantor dying during the term.
2. The term of a GRAT can be compressed, depending upon the anticipated cash flow and exit strategy if cash flow is insufficient to make future annuity payments.  
✓ GRAT wins

### **C. Right to Reacquire Residence**

1. The grantor of a QPRT is prohibited from reacquiring the residence contributed.
2. The grantor of a “House GRAT” funded with a disregarded LLC can reacquire the residence from the disregarded LLC.  
✓ GRAT wins

### **D. Regulatory Rules**

1. QPRTs face stricter regulatory requirements.
2. GRATs are subject to less onerous requirements.  
✓ GRATs win

### **E. Ability to Do Technique with Very Expensive Homes Without Paying Gift Tax**

1. Problematic with QPRTs because the gift will be larger or the term will be longer.

2. Available with GRATs because the gift can be minimized by extending the term and the residence can be purchased from the disregarded entity prior to the expiration of the term.  
✓ GRATs win

## **IX. QPRTs v. IDGTs Sales**

### **A. Sale v. Gift**

1. QPRTs generally use a greater amount of unified credit.
2. Installment note sales to IDGTs use no unified credit in sale (sale for note equal to asset sold) except for seed money to fund IDGT.  
✓ IDGT sales win

### **B. Survivorship Feature**

1. The grantor of a QPRT must survive the term to avoid inclusion of the residence in the grantor's estate.
2. There is no survivorship requirement for IDGTs; the instant the sale is made to the IDGT, the discount and post-transfer appreciation is out of the grantor's estate.  
✓ IDGT sales win

### **C. Right to Reacquire Property**

1. The grantor is prohibited from reacquiring the transferred residence from a QPRT.
2. The grantor of an IDGT may reacquire the residence contributed to the disregarded LLC for equivalent value.  
✓ IDGT sales win

### **D. Regulatory Rules**

1. QPRTs face stricter regulatory requirements.
2. IDGTs do not have any regulatory requirements.  
✓ IDGT sales win

### **E. Generation Skipping**

1. QPRTs are prohibited from generation-skipping because of the ETIP rules.
2. IDGTs are generally structured as generation-skipping trusts and the ETIP rules do not apply to IDGTs.  
✓ IDGT sales win

## X. THE “DOUBLE LLC” STRATEGY\*\*

### A. Basic structure of installment sale to an IDGT

1. An installment sale to an IDGT in exchange for a promissory note is a very popular wealth transfer strategy that offers many significant benefits.
2. Generally, this technique is used to sell non-controlling interests in entities such as limited partnerships, LLCs and corporations (particularly S corporations) to defective dynastic trusts, taking advantage of valuation discounts.
3. The trust is set up as a grantor trust by intentionally violating one or more of the grantor trust rules (IDGT).
4. Typically, the note is structured as interest-only for a period of time with a balloon payment of principal at the end of the term and a right of prepayment without penalty.
5. The trust should be “seeded” with sufficient assets to sustain treatment as a sale rather than risking being recast as a transfer with a retained interest.

### B. Undercapitalization risk

1. If the debt-to-equity ratio of the IDGT is too high, the IRS could attempt to recharacterize the sale to the IDGT as a gift (or part gift) with a retained income interest, exposing the transaction to IRC § 2036.
2. To avoid a “form over substance” or “sham” argument by the IRS, conservative practitioners believe that the IDGT should be independently funded with some seed money.
3. It appears that 10% has been the rule of thumb that most practitioners have used as the amount of “seed money” necessary to support the integrity of an installment note sale transaction. See, however, *McDermott v. Comm’r*, 13 T.C. 468 (1949), acq 1950-1 C.B. 3 where the debt/equity ratio was 19.6 to 1. (Equity was 5.6%)
4. The 10% rule of thumb is based upon an informal conversation Byrle Abbin had with the IRS. Byrle commented: “...Informally, IRS has indicated that the trust should have assets equal to 10 percent of the purchase price to provide adequate security for payment of the acquisition obligation.”  
Byrle M. Abbin, *[S]he Loves Me, [S]he Loves Me Not – Responding to Succession Planning Needs Through a Three-Dimensional Analysis of Considerations to be Applied in Selecting from the Cafeteria of Techniques*, 31 U. of Miami Institute on Estate Planning, Ch. 13 (1997), p. 13-9; See also LTR 9535026, which was issued to Byrle as a result of that meeting.

---

\*\*This portion of the outline combines and extends portions of an outline I did for the State Bar of Texas, *Cutting Edge Techniques to Enhance Popular High-End Wealth Shifting Strategies*,” April 2006, and an outline (and speech) that David Handler of Kirkland and Ellis, LLP, Chicago, Illinois, and I did for the 2005 N.Y.U. Institute on Federal Taxation. I attribute the “Double LLC” concept to David.

### C. The “Double LLC” Concept (See Exhibit H)\*

1. The concept is designed to honor the 10% rule of thumb while expanding the amount that can be transferred.
2. Byrle Abbin has told me that he understood that the 10% rule of thumb means really a 9:1 debt to equity ratio and not 10:1.
3. Assume that the trust has \$1 million of assets; LLC1 holds \$15 million of assets and LLC2 holds \$50 million of assets.
  - a. Assume a 40% valuation discount on the value of the LLC units.
  - b. The IDGT could purchase a 99% interest in LLC1 (assuming that the interest was a non-controlling interest or, alternatively, was sold by H and W equally) for just under \$9 million without exceeding the 10% rule. The trust pays \$1 million as a down payment and issues a promissory note for the remaining \$8 million.
  - c. LLC1 subsequently purchases a 99% interest in LLC2 for about \$33.3 million.
  - d. Because LLC1 has \$15 million of assets and no debt, it also is within the 10% rule of thumb and could purchase up to \$135 million of property for a note.
4. Because LLC1 is owned entirely by the grantor and a grantor trust (the IDGT), there is only one owner of LLC1 (the grantor) for income tax purposes.
  - a. Accordingly, LLC1 should be disregarded as an entity separate from the grantor for income tax purposes and no taxable event occurs upon LLC1’s purchase of LLC2 units from the grantor.
  - b. This is supported by Rev. Rul. 2004-77, in which a partnership was owned by a corporation and an LLC wholly-owned by the corporation. Although there were two partners under local law, because one of those partners (the LLC) was a disregarded entity as to the other partner, the corporation was treated as holding all of the LLC’s interests in the partnership.
  - c. As a result, the partnership had only one owner for federal tax purposes and the partnership was disregarded as an entity for federal tax purposes.
5. However, for gift tax or sales purposes, the asset is valued by the value of what the donee (or purchaser) receives.
6. In Rev. Rul. 2004-88, the Service recognized that despite non-recognition of an entity for federal income tax purposes, the entity nonetheless exists for state law purposes and therefore has a meaningful legal impact on the owners’ rights and economic interests. In that ruling, the Service stated, “Although the

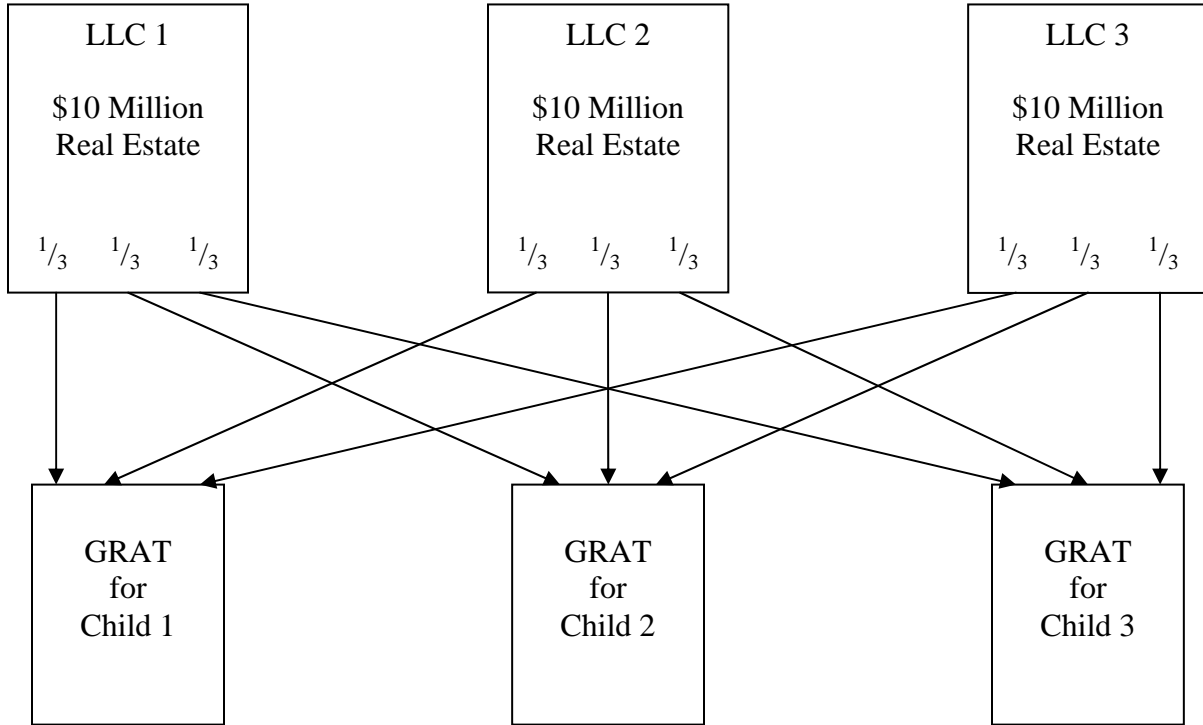
---

\*The author notes that, at first blush, the “Double LLC” concept seems risky. However, the components of the Double LLC strategy, standing alone, are more traditional. The “Double LLC” concept is not a strategy for every client and the client should be advised of the potential risks.

the regulations under sections 301.7701-1 through 301.7701-3 provide that a disregarded entity is disregarded for all federal tax purposes, these regulations do not alter state law, which determines a partner's status as a general partner .... Although LLC is a disregarded entity for federal tax purposes, LLC remains a partner in P and is the sole general partner authorized to bind the partnership under state law.”

7. Thus, LLC1 should be treated as having two owners (the grantor and the trust) for gift tax purposes and should not be disregarded as an entity under IRC § 7701 for gift tax purposes.
  - a. Therefore, the sale of LLC2 units to LLC1 should not be treated as a sale of LLC2 units to the grantor trust for gift tax purposes and the trust should not be treated as exceeding the 10% rule of thumb.
  - b. The sale of LLC2 units to LLC1 should be treated as such, and LLC1's debt to equity ratio considered as one of several factors in determining whether the note issued by LLC1 is debt or equity.
8. For the same reasons, if the grantor dies owning units in an LLC that is wholly owned by the grantor and a grantor trust, the LLC will have two owners for estate tax purposes.
  - a. As a result, valuation discounts may apply in determining the estate tax value of the grantor's LLC units.
  - b. Moreover, the LLC would not be disregarded for purposes of the basis adjustment under Section 1014 even though basis is an income tax concept, because the basis is adjusted to the “value placed on such property for purposes of the Federal estate tax.” Treas. Reg. § 1.1014-1(a). Thus, the basis in the grantor's LLC units will be adjusted to the (discounted) estate tax value of the LLC units.

## Exhibit A – Disregarded Entity



## Exhibit B – Level GRAT

**Facts:**  
**A typical client owning a business using a level GRAT with a 40% discount, cash flow is 5%, growth is 5%, § 7520 rate is 5%.**

Grantor Retained Annuity Trust 9/12/2005

---

Type of Calculation:	Term
Transfer Date:	9/2005
§7520 Rate:	5.00%
Grantor's Age(s):	
Income Earned by Trust:	5.00%
Term of Trust:	10
Total Number of Payments:	10
Annual Growth of Principal:	5.00%
Pre-discounted FMV:	\$10,000,000
Discounted FMV:	\$6,000,000
Percentage Payout:	12.95051%
Exhaustion Method:	IRS
Payment Period:	Annual
Payment Timing:	End
Vary Annuity Payments?	No
Is Transfer To or For the Benefit of a Member of the Transferor's Family?	Yes
Is Interest in Trust Retained by Transferor or Applicable Family Member?	Yes
With Reversion?	No

**\*\*\* §2702 IS Applicable \*\*\***

Base Term Certain Annuity Factor:	7.7217
Frequency Adjustment Factor:	1.0000
Annual Annuity Payout:	\$777,030.60
Initial Amount of Payment Per Period:	\$777,030.60
Value of Term Certain Annuity Interest	\$5,999,997.18
Value of Grantor's Retained Interest:	\$5,999,997.18
(1) Taxable Gift (Based on Term Interest):	\$2.82

### Economic Schedule Principal value based on Pre-discounted FMV of contributed property

<u>Year</u>	<u>Beginning Principal</u>	<u>5.00% Growth</u>	<u>5.00% Annual Income</u>	<u>Annual Payment</u>	<u>Remainder</u>
1	\$10,000,000.00	\$500,000.00	\$512,500.00	\$777,030.60	\$10,235,469.40
2	\$10,235,469.40	\$511,773.47	\$524,567.81	\$777,030.60	\$10,494,780.08
3	\$10,494,780.08	\$524,739.00	\$537,857.48	\$777,030.60	\$10,780,345.96
4	\$10,780,345.96	\$539,017.30	\$552,492.73	\$777,030.60	\$11,094,825.39
5	\$11,094,825.39	\$554,741.27	\$568,609.80	\$777,030.60	\$11,441,145.86
6	\$11,441,145.86	\$572,057.29	\$586,358.73	\$777,030.60	\$11,822,531.28
7	\$11,822,531.28	\$591,126.56	\$605,904.73	\$777,030.60	\$12,242,531.97
8	\$12,242,531.97	\$612,126.60	\$627,429.76	\$777,030.60	\$12,705,057.73
9	\$12,705,057.73	\$635,252.89	\$651,134.21	\$777,030.60	\$13,214,414.23
10	\$13,214,414.23	\$660,720.71	\$677,238.73	\$777,030.60	\$13,775,343.07
Summary	\$10,000,000.00	\$5,701,555.09	\$5,844,093.98	\$7,770,306.00	\$13,775,343.07

## Exhibit C – Graduated GRAT

**Facts: A typical client owning a business using a graduated GRAT with a 40% discount, cash flow is 5%, growth is 5%, § 7520 rate is 5%.**

Grantor Retained Annuity Trust

9/12/2005

Type of Calculation:	Term
Transfer Date:	9/2005
§7520 Rate:	5.00%
Grantor's Age(s):	
Income Earned by Trust:	5.00%
Term of Trust:	10
Total Number of Payments:	10
Annual Growth of Principal:	5.00%
Pre-discounted FMV:	\$10,000,000
Discounted FMV:	\$6,000,000
Percentage Payout:	5.35492%
Exhaustion Method:	IRS
Payment Period:	Annual
Payment Timing:	End
Vary Annuity Payments?	Yes
Is Transfer To or For the Benefit of a Member of the Transferor's Family?	Yes
Is Interest in Trust Retained by Transferor or Applicable Family Member?	Yes
With Reversion?	No

**\*\*\* §2702 IS Applicable \*\*\***

Base Term Certain Annuity Factor:	18.6744
Frequency Adjustment Factor:	1.0000
Annual Annuity Payout:	\$321,295.20
Initial Amount of Payment Per Period:	\$321,295.20
Annual Annuity Payment Growth:	20.00%
Value of Term Certain Annuity Interest	\$5,999,995.08
Value of Grantor's Retained Interest:	\$5,999,995.08
(1) Taxable Gift (Based on Term Interest):	\$4.92

### Economic Schedule

**Principal value based on Pre-discounted FMV of contributed property**

<u>Year</u>	<u>Beginning Principal</u>	<u>5.00% Growth</u>	<u>5.00% Annual Income</u>	<u>Annual Payment</u>	<u>Remainder</u>
1	\$10,000,000.00	\$500,000.00	\$512,500.00	\$321,295.20	\$10,691,204.80
2	\$10,691,204.80	\$534,560.24	\$547,924.25	\$385,554.24	\$11,388,135.05
3	\$11,388,135.05	\$569,406.75	\$583,641.92	\$462,665.09	\$12,078,518.63
4	\$12,078,518.63	\$603,925.93	\$619,024.08	\$555,198.11	\$12,746,270.53
5	\$12,746,270.53	\$637,313.53	\$653,246.36	\$666,237.73	\$13,370,592.69
6	\$13,370,592.69	\$668,529.63	\$685,242.88	\$799,485.27	\$13,924,879.93
7	\$13,924,879.93	\$696,244.00	\$713,650.10	\$959,382.33	\$14,375,391.70
8	\$14,375,391.70	\$718,769.59	\$736,738.82	\$1,151,258.79	\$14,679,641.32
9	\$14,679,641.32	\$733,982.07	\$752,331.62	\$1,381,510.55	\$14,784,444.46
10	\$14,784,444.46	\$739,222.22	\$757,702.78	\$1,657,812.66	\$14,623,556.80
Summary	\$10,000,000.00	\$6,401,953.96	\$6,562,002.81	\$8,340,399.97	\$14,623,556.80

## Exhibit D – Advantages of Short Term GRATs

<b>Table A – Growth Pattern</b>		
Year	% Growth	Value at Year End
1	15%	\$1,150,000
2	7%	\$1,230,500
3	-10%	\$1,107,450
4	-5%	\$1,052,076
5	6%	\$1,115,202
6	10%	\$1,226,722

<b>Table B – 6-Year GRAT</b>			
Year	% Growth	Payment to Grantor	Value at Year End
1	15%	\$197,000	\$953,000
2	7%	\$197,000	\$822,710
3	-10%	\$197,000	\$543,439
4	-5%	\$197,000	\$319,267
5	6%	\$197,000	\$141,423
6	10%	\$197,000	\$0

<b>Table C – 3 Successive 2-Year GRATs</b>					
Year	Initial Principal	% Growth	Payment to Grantor	Value of GRAT at Year End	Payment to Remainder Beneficiary
FIRST GRAT	\$1,000,000				
1		15%	\$537,800	\$612,200	
2		7%	\$537,800	\$117,254	\$117,254
SECOND GRAT	\$1,113,246				
1		-10%	\$598,704	\$403,217	
2		-5%	\$598,704	\$0	\$0
THIRD GRAT	\$951,825				
1		6%	\$511,891	\$497,044	
2		10%	\$511,891	\$34,857	\$34,857

**Facts:** \$1 million asset transferred to a 6-year GRAT; AFR 5%

**Comparative Results** **Table B – 6-Year GRAT** – no wealth shift due to poor performance in years 3 and 4

**Table C – 3 Successive 2-Year GRATs** – wealth shift of \$152,111

## Exhibit E - QPRT

### Facts:

**60-year old client owning residence worth \$2 million transfers residence to QPRT (assume the application of a 30% discount of the residence, a fair annual rental of 3%, anticipated growth is 2% and the § 7520 rate is 3.4%)**

### Qualified Personal Residence Trust

---

Transfer Date:	9/2009
§ 7520 Rate:	3.40%
Principal:	\$1,400,000
Grantor's Current Age:	60
Term of Trust	15
After-Tax Growth	2.00%
Comb. Death Tax Bracket:	45.00%
With Reversion?	Yes

Grantor's Age When Trust Term Ends:	75
Value of Nontaxable Interest Retained by Grantor:	\$800,828
Taxable Gift (Present Value of Remainder Interest):	\$599,172
Property Value After 15 Years:	\$1,884,216
Potential Death Tax Savings:	\$578,270
Qualified Annuity that Must be Paid Annually (if Entire Trust Ceases to be a QPRT):	\$77,867

## Exhibit F – House GRAT

**Facts:**

**60-year old client owning residence worth \$2 million transfers residence to disregarded LLC, then transfers interests in LLC to GRAT (assume the application of a 30% discount, a fair annual rental of 3%, anticipated growth is 2% and the § 7520 rate is 3.4%)**

Grantor Retained Annuity Trust

Type of Calculation:	Term
Transfer Date:	9/2009
§ 7520 Rate:	3.40%
Grantor's Age:	60
Income Earned by Trust	3.00%
Term:	15
Total Number of Payments:	15
Annual Growth of Principal:	2.00%
Pre-discounted FMV:	\$2,000,000
Discounted FMV:	\$1,400,000
Percentage Payout:	1.99264%
Exhaustion Method:	IRS
Payment Period:	Annual
Payment Timing:	End
Vary Annuity Payments:	Yes
With Reversion:	No

**\*\*§2702 IS Applicable\*\***

Base Term Certain Annuity Factor:	50.1845
Frequency Adjustment Factor:	1.0000
Initial Annual Annuity Payout:	\$27,896.96
Initial Amount of Payment Per Period:	\$27,896.96
Annual Annuity Payment Growth:	20.00%
Value of Term Certain Annuity Interest	\$1,399,994.99
Value of Grantor's Retained Interest:	\$1,399,994.99
Taxable Gift (Based on Term Interest):	\$5.01

### Economic Schedule

#### Principal Value Based on Pre-Discounted FMV of Contributed Property

Year	Beginning		3.00% Annual		Annual Payment	Remainder
	Principal	2.00% Growth	Income	Income		
1	\$2,000,000.00	\$40,000.00	\$60,600.00	\$60,600.00	\$27,896.96	\$2,072,703.04
2	\$2,072,703.04	\$41,454.06	\$62,802.90	\$62,802.90	\$33,476.35	\$2,143,483.65
3	\$2,143,483.65	\$42,869.67	\$64,847.55	\$64,847.55	\$40,171.62	\$2,211,129.25
4	\$2,211,129.25	\$44,222.59	\$66,997.22	\$66,997.22	\$48,205.95	\$2,274,143.11
5	\$2,274,143.11	\$45,482.86	\$68,906.54	\$68,906.54	\$57,847.14	\$2,330,685.37
6	\$2,330,685.37	\$46,613.71	\$70,619.77	\$70,619.77	\$69,416.56	\$2,378,502.29
7	\$2,378,502.29	\$47,570.05	\$72,068.62	\$72,068.62	\$83,299.88	\$2,414,841.08
8	\$2,414,841.08	\$48,296.82	\$73,169.68	\$73,169.68	\$99,959.85	\$2,436,347.73
9	\$2,436,347.73	\$48,726.95	\$73,821.34	\$73,821.34	\$119,951.82	\$2,438,944.20
10	\$2,438,944.20	\$48,778.88	\$73,900.01	\$73,900.01	\$143,942.19	\$2,417,680.90
11	\$2,417,680.90	\$48,353.62	\$73,255.73	\$73,255.73	\$172,730.62	\$2,366,559.63
12	\$2,366,559.63	\$47,331.19	\$71,706.76	\$71,706.76	\$207,276.75	\$2,278,320.83
13	\$2,278,320.83	\$45,566.42	\$69,033.12	\$69,033.12	\$248,732.10	\$2,144,188.27
14	\$2,144,188.27	\$42,883.77	\$64,968.90	\$64,968.90	\$298,478.52	\$1,953,562.42
15	\$1,953,562.42	\$39,071.25	\$59,192.94	\$59,192.94	\$358,174.22	\$1,693,652.39
Summary	\$2,000,000.00	\$677,221.84	\$1,025,991.08	\$1,025,991.08	\$2,009,560.53	\$1,693,652.39

## Exhibit G – House IDGT

**Facts:**

**60-year old client owning residence worth \$2 million transfers residence to disregarded LLC, then transfers interests in LLC to via installment note sale to IDGT (assume the application of a 30% discount, a fair annual rental of 3%, anticipated growth is 2% and the mid-term AFR is 2.87%)**

Intentionally Defective Grantor Trust

---

FMV of Gift to IDGT:	\$160,000
Pre-Discount Value of LLC Interests Sold to Trust:	\$2,000,000
Discount Applied to LLC Interests:	30.00%
Term of Note:	9 years
Applicable Federal Rate:	2.87%
Net Growth:	2.00%
Fair Market Rental:	3.00%
Value of LLC Interests (no discounts) Sold to IDGT:	\$2,000,000
Discounted Value of LLC Interests Sold to IDGT:	\$1,400,000
Total Discounted Value of IDGT Assets (with Gifts):	\$1,560,000
Net Value of Dynasty Trust Assets at End of Note (no Discount):	\$789,459
Amount Given to Trust:	\$160,000
Amount Removed from Estate:	\$789,459

### Economic Schedule

<u>Year</u>	<u>Undiscounted Value (beginning of year)</u>	<u>2.0% Growth</u>	<u>3.0% Annual Rental</u>	<u>Interest and Principal on Note</u>	<u>Undiscounted Value (end of Year)</u>
1	\$2,160,000.00	\$43,200.00	\$60,000.00	\$40,180.00	\$2,223,020.00
2	\$2,223,020.00	\$44,460.40	\$60,000.00	\$40,180.00	\$2,287,300.40
3	\$2,287,300.40	\$45,746.01	\$60,000.00	\$40,180.00	\$2,352,866.41
4	\$2,352,866.41	\$47,057.33	\$60,000.00	\$40,180.00	\$2,419,743.74
5	\$2,419,743.74	\$48,394.87	\$60,000.00	\$40,180.00	\$2,487,958.61
6	\$2,487,958.61	\$49,759.17	\$60,000.00	\$40,180.00	\$2,557,537.78
7	\$2,557,537.78	\$51,150.76	\$60,000.00	\$40,180.00	\$2,628,508.54
8	\$2,628,508.54	\$52,570.17	\$60,000.00	\$40,180.00	\$2,700,898.71
9	\$2,700,898.71	\$54,017.97	\$60,000.00	\$1,440,180.00	\$1,374,736.68

## Exhibit H – “Double LLC Strategy”

