

Estate Planning With Disregarded Entities

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Goal

- **To Transfer Substantial Wealth**
 - ❖ **Transfer tax-free**
 - ❖ **Income tax-free**

Sample Client Profile

- \$10 million real estate property
- Cash flow 5%, appreciation 5%
- Three children
- Desire to give 1/3 to each child
- Assume 40% valuation discount
- Assume
 - ❖ AFR 6%
 - ❖ Annual Midterm Rate 5%

Our Unique Problem

- ❑ Major assets have a low cash flow - 5%
- ❑ GRAT - Actual payment of the annual annuity must be made. Treas. Regs. §25.2702-3
- ❑ IDGT - Interest and balloon payment must be paid
- ❑ Desire to contribute discountable assets and receive back non-discountable assets

Concepts we will be using

- ❑ Income Tax Defective Trust
- ❑ Disregarded Entity
- ❑ The Estate Planner's Dream –
“Passing on More Than Meets the
Taxable Eye”

Planning

The Estate Planner's Dream

- Transfer discountable, income – producing property
- Receive back cash (or non-discountable assets)
 - *In effect, the discount is passed on tax-free to the donor*
- In a tax-free transfer

Disregarded Entity

- ❑ Single owner entity that has not elected to be classified as an association (corporation)
- ❑ Entity existence ignored
 - A “tax nothing”
- ❑ Concept similar to Defective Trust Concept

GRAT/DISREGARDED ENTITY COMBO

GRAT

- ❑ Gift to trust in exchange for an annuity substantially equal in value to transferred property
- ❑ Generally annuity increases by 20% a year

Low Cash Flow GRAT



For transfer tax purposes, no aggregation of transfers to separate trusts. Rev. Rul. 93-12

GRAT Illustration

Graduated 10-Year: 5% income, 5% growth

§7520 Rate:	6.00%
Income Earned by Trust:	5.00%
Term:	10
Annual Growth of Principal:	5.00%
Pre-discounted FMV:	\$10,000,000
Discounted FMV:	\$6,000,000
Percentage Payout:	5.69699%
Annual Annuity Payment Growth:	20.00%
Value of Grantor's Retained Interest:	\$5,999,990.11
Taxable Gift:	\$9.89

GRAT Illustration

Graduated 10-Year: 5% income, 5% growth

YEAR	BEGINNING PRINCIPAL	5.00% GROWTH	5.00% ANNUAL INCOME	ANNUAL PAYMENT	REMAINDER
1	\$10,000,000.00	\$500,000.00	\$512,500.00	\$341,819.40	\$10,670,680.60
2	\$10,670,680.60	\$533,534.03	\$546,872.38	\$410,183.28	\$11,340,903.73
3	\$11,340,903.73	\$567,045.19	\$581,221.32	\$492,219.94	\$11,996,950.30
4	\$11,996,950.30	\$599,847.52	\$614,843.70	\$590,663.92	\$12,620,977.60
5	\$12,620,977.60	\$631,048.88	\$646,825.10	\$708,796.71	\$13,190,054.87
6	\$13,190,054.87	\$659,502.74	\$675,990.31	\$850,556.05	\$13,674,991.87
7	\$13,674,991.87	\$683,749.59	\$700,843.33	\$1,020,667.26	\$14,235,557.22
8	\$14,038,917.53	\$701,945.88	\$719,494.52	\$1,224,800.71	\$14,415,452.38
9	\$14,235,557.22	\$711,777.86	\$729,572.31	\$1,469,760.85	\$14,207,146.54
10	\$14,207,146.54	\$710,357.33	\$728,116.26	\$1,763,713.02	\$13,881,907.11
SUMMARY	\$10,000,000.00	\$6,298,809.02	\$6,456,279.23	\$8,873,181.14	\$13,881,907.11

Options to Pay Annuity

- “In Kind” distributions of LLC interests
 - ❖ Grantor trust – no income tax on payments “in kind” of appreciated property
 - ❖ Discountable
 - ❖ Appraisal and valuation problems
 - ❖ Future growth back in estate
 - *Reduces wealth transfer*
 - *Violates to goal of receiving assets back not subject to discounts*

Options to Pay Annuity

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□ Purchase the property from the LLC

- ❖ LLC owns 100 % of property
- ❖ Purchase is of 100% of property
- ❖ No discount
- ❖ Can be by note
 - *Potential cash flow issue*
 - *Can use GRAT annuity payments to alleviate cash flow problems*

How Does The “Disregarded Entity”/GRAT Income Tax Combo Work?

- GRATs are grantor trusts. IRC §§673(a),677(a)
- Each GRAT is “owned” by the grantor for income tax purposes
- Entity with a single owner is disregarded. IRC §7701

GRAT Illustration

Graduated 20-Year: 2% income, 6% growth

§7520 Rate:	6.00%
Income Earned by Trust:	2.00%
Term:	20
Annual Growth of Principal:	6.00%
Pre-discounted FMV:	\$10,000,000
Discounted FMV:	\$6,000,000
Percentage Payout:	1.27810%
Annual Annuity Payment Growth:	20%
Value of Grantor's Retained Interest:	\$5,999,996.99
Taxable Gift:	\$3.01

GRAT Illustration

Graduated 20-Year: 2% income, 6% growth

YEAR	BEGINNING PRINCIPAL	6.00% GROWTH	2.00% ANNUAL INCOME	ANNUAL PAYMENT	REMAINDER
1	\$10,000,000.00	\$600,000.00	\$206,000.00	\$76,686.00	\$10,729,314.00
2	\$10,729,314.00	\$643,758.84	\$221,023.87	\$92,023.20	\$11,502,073.51
3	\$11,502,073.51	\$690,124.41	\$236,942.71	\$110,427.84	\$12,318,712.79
4	\$12,318,712.79	\$739,122.77	\$253,765.48	\$132,513.41	\$13,179,087.63
5	\$13,179,087.63	\$790,745.26	\$271,489.21	\$159,016.09	\$14,082,306.01
20	\$25,897,090.02	\$1,553,825.40	\$533,480.05	\$2,449,964.32	\$25,534,431.15
SUMMARY	\$10,000,000.00	\$22,221,429.62	\$7,629,357.47	\$14,316,355.94	\$25,534,431.15

**NOTE SALE TO
IDGT/ DISREGARDED
ENTITY COMBO**

IDGT – NOTE SALE

- **Non-controlling interest sold to income tax defective trust in exchange for an installment note, generally interest only with a balloon payment.**

Low Cash Flow Note Sale



For transfer tax purposes, no aggregation of transfers to separate trusts. Rev. Rul. 93-12

Note Sale to IDGT with Low Cash Flow Asset

- Interest paid from
 - ◇ “Seed” money
 - ◇ Cash flow

- When “seed” money and cash flow insufficient – buy asset from entity

Alternatives to QPRTs

**Qualified Personal
Residence Trusts
and
Alternative Solutions**

What is a QPRT?

- ❑ Grantor transfers residence to trust
- ❑ Grantor retains:
 - ❖ Right to use and occupy residence for specified term; and
 - ❖ Contingent reversionary interest

QPRT Disadvantages Which We Want to Eliminate or Reduce

- ❑ Large gift
- ❑ Mortality Risk
- ❑ Prohibition against reacquisition
 - To obtain step-up in basis at death
 - To live in residence
- ❑ Complex, rigid regulatory requirements

QPRT

Strict Regulatory Rules

- Reg. §25.2702-5(c) contains a long list of requirements
- Reacquisition of residence prohibited either during or after the term

Reg. §25.2702-5(b)(9)

QPRT v. GRAT

- **Unified credit used**
 - QPRT substantial
 - GRAT insignificant
 - To own
 - To obtain basis step-up
- **Term – risk of inclusion**
 - QPRT substantial
 - GRAT term can be condensed
- **Right to reacquire property in GRAT**

QPRP v. IDGT

- ❑ Sale v. Gift
- ❑ Survivorship feature
- ❑ Right to reacquire property
 - * To own
 - * To obtain basis step-up
- ❑ Generation-skipping