

# **Recent Developments in Estate Planning**

## **CASE STUDY**

### **PLAN**

**NORTHERN CALIFORNIA REGIONAL FINANCIAL  
PLANNING CONFERENCE**

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## II. THE PLAN

### A. Qualified Personal Residence Trusts (QPRTs)

Two QPRTs will be established for their Lake Tahoe home. Dale will transfer his 50% interest and Maggie will transfer her 50% interest to separate Trusts. Because each of them is contributing an undivided 50% interest in the property, the value of the property will be discounted by 20% to reflect the lack of control and lack of marketability of a 50% interest. The QPRT will have a 12 year term after which the children, Joe and Amy, will each receive a 50% interest in the property. As a result of the transfers to the QPRTs, there is a total gift of \$552,060 (\$276,030 each). This amount reduces their lifetime credit amount of \$1 million each leaving them with \$723,970 each to gift tax free.

### B. Family Limited Partnerships (FLP)

We decided to convene a family meeting to discuss with the parents and children the manner in which their estate is to be distributed and to hear their concerns and wishes. Amy expressed a desire to eventually own some of the real properties her parents inherited and she would be happy if we tried to equalize the estate with her brother by utilizing some of these properties.

As a result, we decided to form two (2) FLPs — one of which will eventually pass to Amy and one that will eventually pass to Joe. The children understand that the values, although equivalent today, may differ in the future when Dale and Maggie pass away.

#### 1. The D&M Family Limited Partnership I

Dale and Maggie will form The D&M Family Limited Partnership I and contribute to it the real property described below as well as over \$4 million of marketable securities. Amy forms A-1 Management LLC as the sole member with assets gifted to her from her parents. The LLC will be the 1% general partner of the FLP and Dale and Maggie, as Trustees of their revocable Trust, will be the 99% Limited Partner.

Dale and Maggie hire a professional appraiser to determine the fair market value of the real properties contributed to the FLP and an appraiser to determine the fair market value of a 1% limited partnership interest in the FLP.

The Net Asset Value of FLP I is determined by appraisal to be as follows:

Assets:

Marketable Securities \$4,837,000

Retail Property #1 4,200,000

50% - Retail Property #2 1,160,000

Office Building #1 10,090,000

50% - Office Building #2 2,520,000

50% - Warehouse 936,000

Total Assets: \$23,743,000

Total Liabilities: \$ 0

Net Asset Value: \$23,743,000

The Fair Market Value of a 1% Limited Partnership interest in FLP I is determined by appraisal to be as follows:

Total Net Asset Value of Real Estate:\$18,906,000

multiplied by 1%: 189,060

less 45% discount for lack of control

and lack of marketability: (85,077)

total 103,983

Total Net Asset Value of Marketable

Securities: \$4,837,000

multiplied by 1%: 48,370

less 15% discount for lack of control

and lack of marketability (7,256)

total 41,114

Fair Market Value of 1% LP Interest \$145,097 (\$103,983 + \$41,114)

This represents a 38.89% discount from the Net Asset Value of FLP I.

The ownership of The D&M Family Limited Partnership I after formation is as follows:

A-1 Management LLC 1% General Partner

Dale and Maggie, Trustees 99% Limited Partner

## 2. The D&M Family Limited Partnership II

Dale and Maggie will form The D&M Family Limited Partnership II and contribute to it the real properties described below as well as \$4 million of marketable securities. Joe will form J-1 Management LLC as sole member with assets gifted to him by his parents. The LLC will be the 1% general partner of FLP II and Dale and Maggie, as Trustees of their revocable Trust, will be the 99% Limited Partner.

Dale and Maggie hire a professional appraiser to determine the fair market value of the real properties contributed to FLP II and an appraiser to determine the fair market value of a 1% limited partnership interest in FLP II.

The Net Asset Value of FLP II is determined by appraisal to be as follows:

Assets:

Marketable Securities \$4,000,000

50% - Retail Property #2 1,160,000

Retail Property #3 2,150,000

50% - Office Building #2 2,520,000

50% - Warehouse 936,000

Total Assets: \$10,766,000

Total Liabilities: \$ 0

Net Asset Value: \$10,766,000

The Fair Market Value of a 1% Limited Partnership interest in FLP II is determined by appraisal to be as follows:

Total Net Asset Value of Real Estate: \$6,766,000

multiplied by 1%: 67,660

less 45% discount for lack of control

and lack of marketability: (30,447)

total 37,213

Total Net Asset Value of Marketable

Securities: \$4,000,000

multiplied by 1%: 40,000

less 15% discount for lack of control

and lack of marketability (6,000)

total 34,000

Fair Market Value of 1% LP Interest \$71,213 (\$37,213 + \$34,000)

This represents a 33.85% discount from the Net Asset Value of FLP II.

The ownership of The D&M Family Limited Partnership II after formation is as follows:

J-1 Management LLC 1% General Partner

Dale and Maggie, Trustees 99% Limited Partner

C. Grantor Retained Annuity Trust (GRAT)

## 1. GRAT I

Dale and Maggie will contribute a 49% Limited Partnership Interest in FLP I and a 49% Limited Partnership interest in the FLP II to the Dale and Maggie Grantor Retained Annuity Trust I. We did not gift more than 50% of the limited partnership interests to avoid triggering a reassessment of the real estate. GRAT I will have a 12 year term, after which, it will terminate and the trust principal, the 49% LP interest in FLP I and the 49% LP interest in FLP II, will be distributed to Amy and Joe respectively. Pursuant to our calculations (using a May 2004 Section 7520 Rate of 3.8%), the trust will pay out to Dale and Maggie an Annuity amount of \$1,097,319.30 (in monthly installments of \$91,433.28). The GRAT I's pro-rata share of the FLP I's and FLP II's monthly rental income is approximately \$131,000. Thus, there will be more than enough cash flow from the properties for the FLPs to make a distribution of \$91,433.28 each month to GRAT I and for the trust, in turn, to make its pay-out to Dale and Maggie. Structuring GRAT I in this manner results in a gift tax value of only \$5.37 (i.e. a "Walton" type GRAT). At the end of the Trust term of 12 years, the LP Interests pass to the children with virtually no transfer tax cost. In addition, any growth in value of the underlying LP interests also passes free of additional transfer tax (e.g. if the LP interest doubles in value in 12 years, it passes to the children without further tax).

## 2. GRAT II and III

Dale and Maggie will each contribute 50% of their stock in SpamStopper, Inc. to separate Trusts, the Dale Grantor Retained Annuity Trust II and The Maggie Grantor Retained Annuity Trust III. GRAT II and III will each have a 12 year term, after which, it will terminate and the trust principal (i.e. 50% of the company stock in each trust) will be distributed to Joe making him the sole shareholder. During the term of each GRAT, Dale and Maggie, as Trustees of the respective GRATs, retain the right to vote the shares owned by the Trusts. Pursuant to an appraisal of 50% of the company stock, the fair market value is as follows:

100% of SpamStopper, Inc. \$13,120,000

50% - unadjusted value 6,560,000

Less: 45% discount for lack of

control and marketability (2,952,000)

FMV of 50% of common stock \$3,608,000

Each trust will pay out to Dale and Maggie an Annuity amount of \$374,709.92 (in quarterly installments of \$93,677.48). Dale, retiring as President and CEO, will no longer receive his annual salary and bonuses of approximately \$700,000 resulting in net income to the company of said amount. This leaves the company at least \$700,000 each year to distribute to its shareholders: Dale, as Trustee of GRAT II - 50% shareholders (\$350,000), and Maggie, as Trustee of GRAT III, as 50% shareholder (\$350,000). Given the company's history of annual revenue growth, it is very likely that the company's net income will be more than sufficient to make quarterly distributions to the shareholders that will enable GRAT II and III to meet its quarterly pay out amount. Structuring GRAT II and III in this manner results in a gift tax value of only \$1.33 each (i.e. again a "Walton" type GRAT). At the end of the GRAT II and GRAT III term of 12 years, each Trust will terminate and distribute 50% of the common stock of SpamStopper, Inc. to Joe with virtually no transfer tax cost.

D. Charitable Planning/Charitable Lead Trust (CLT)

1. Direct Bequest of IRA's to Charity.

Dale and Maggie designate their favorite local charity as beneficiary of their respective IRAs.

2. Creation of Charitable Lead Unitrust.

Dale and Maggie also establish the D&M Charitable Lead Unitrust and contribute to it \$1,000,000 of marketable securities. The Trust will have a 12 year term and pay-out 7% of the trust assets each year to the charitable organization designated by Dale and Maggie. They will receive a current gift and income tax charitable deduction of \$567,339 and will have been deemed to make a gift to their children (as remainder beneficiaries) of \$432,661. After the 12 year term of the trust has expired, the remainder of the Trust assets will be distributed to the children without any further gift tax consequences. Assuming the trust principal can be invested at a 10% annual return, the children will receive approximately \$1,425,000 upon trust termination for a gift tax value of 432,661. (Assuming a direct gift of \$432,661 was made to the children and they invested it at the same 10% annual return, after 12 years they would have accumulated about \$1,350,000 and there would not have been any intervening distributions to charity.) The charity will receive approximately \$995,000 over the 12 year term.

A. A Look at Dale and Maggie after the Planning Steps Detailed Above

1. Summary of Gifts to Joe and Amy is as follows:

Amy Joe

1. QPRT \$276,030 \$276,030
2. Real Property 189,060 67,660
3. Marketable Securities 48,370 40,000
4. CLT 216,331 216,331

Total Gifts \$729,791 \$597,021

Dale & Maggie's Remaining

Lifetime Gift Exemption Amount

to be applied to Joe and Amy \$270,209 \$402,979

2. Amendments to Estate Planning Documents

- a. Dale and Maggie's Revocable Trust will be amended to make specific bequests of LP interests in FLP I to Amy and FLP II to Joe net of estate tax.
- b. The Trust will also be amended to establish GST Exempt Trusts for the grandchildren utilizing Dale and Maggie's GST Exemption Amount available upon

their respective deaths. We assumed a total of \$4 million would be the combined exemption in 12 years. The estate tax attributable to the Exempt Amount passing to the grandchildren will be paid equally from the residue of the estate such that the entire \$4 million will pass to the grandchildren estate and GST tax free. Given the size of the Estate already passing to Joe and Amy, Dale and Maggie feel this is fair.

### 3. Funding of 529 plans for Grandchildren.

Dale and Maggie will also currently fund a 529 Plan for each of their grandchildren and contribute the maximum amount for 2004, \$110,000 (\$55,000 each), in cash.

No strategies in this plan involve the payment of gift tax. Given the current state of the law, the payment of gift tax today would be unwise. When the exemption amounts and duration of the estate tax become more definite, it may be best to make further gifts to the children and grandchildren. We have left some of their lifetime exemption available to make additional gifts in the future.

### 4. Balance Sheet Immediately After Gifts

The fair market value balance sheet of assets for Dale and Maggie immediately after the above gifts is as follows:

Cash \$ 870,000

Investments

Bond Portfolio 2,400,000

Stock Portfolio 7,288,000

Dale's IRA 3,075,000

Maggie's IRA 750,000

50% LP in FLP I 7,254,850

50% LP in FLP II 3,560,650

GRAT I 10,599,190

GRAT II 3,608,000

GRAT III 3,608,000

Real Estate

Los Gatos Residence 3,000,000

Lake Tahoe QPRTs 1,120,000

Maggie's Artwork

Inventory — to be sold 50,000

Total Assets \$47,183,040

Total Liabilities \$0

Total Equity \$47,183,040

### 5. Annual Gross Income

Annual Gross Income is expected to be as follows:

Sales — Art (Maggie) 50,000

Interest Income 100,000

Dividend Income 60,000

50% LP in FLP I 1,147,040

50% LP in FLP II 427,960

GRAT I 1,097,391

GRAT II 374,709

GRAT III 374,709

Annual Total \$3,631,809

Taxes (combined 45% rate) (1,634,314)

After Tax Annual Income \$1,997,495

### 1. Balance Sheet in 12 Years

The fair market value balance sheet of assets (not including discounts) for Dale and Maggie assuming they both survive the next 12 years and assuming a 6% annual growth rate on their assets will be as follows:

Cash \$1,558,037

Investments

Bond Portfolio 4,298,064

Stock Portfolio 13,051,698

50% LP in FLP I 23,887,000

50% LP in FLP II 10,831,654

Real Estate

Los Gatos Residence 5,372,543

Total Assets \$59 million (approx)

Total Liabilities \$0

Total Equity \$59 million (approx)

## 2. Estate Tax in 12 years

Value of Estate w/o Planning: \$140 million

Estate Tax: \$63,000,000

Value of Estate w/ Planning and including Discounts: \$44 million

Estate Tax: \$19,500,000

Estate Tax Savings as a result of planning: \$43,500,000 (\$63,000,000 of estate tax in 2016 under current plan less \$19,500,000 of estate tax under proposed plan)

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## F. Life Insurance Trust — Premium Financing

As you can see, there is an approximate estate tax in 12 years of \$20,000,000. The clients do not want their children to be forced to liquidate assets within 9 months to pay the tax so they have decided to purchase a \$20 million dollar policy. They already have \$3 million in an ILIT they created several years ago with a cash value of \$2 million. They have decided to purchase another \$20 million so that the \$3 million they already purchased will provide a little cushion. Although they have ample cash flow and income to cover the payment of the premiums themselves, they have decided to finance the premiums to take advantage of low interest rates, at least for the next few years. The clients are aware that in the future they

may need to begin paying the premiums by way of gift to the existing ILIT. They have ample assets to pay the loan back if interest rates should rise. They are willing to assume the risk of higher interest rates. They do not want the policy to be included in their estate for estate tax purposes and under no circumstances do they want to execute a personal guarantee. They would like to use the existing ILIT instead of creating another.

Therefore, we negotiate on behalf of the clients that the ILIT will borrow the necessary funds from a third party lender in order to pay the annual premiums on a \$20 million life insurance policy to be purchased by the ILIT. The loan and policy are structured such that the net death benefit after the repayment of the loan will be \$20 million. The Lender agrees to accept as collateral a pledge of the \$2 million of cash value already owned by the ILIT without requiring a personal guarantee. The loan is structured as a 5 year loan, renewable annually. The arrangement is structured such that if interest rates rise or the loan is not renewed, the ILIT will have enough cash value to pay off the loan and interest in 10 years if need be. In addition, they will continue gifting to the ILIT utilizing their annual exclusion amounts to increase the cash value as well. (See the numbers from the prior segment on Premium Financing to get an idea of how this will work).

Following the death of both Dale and Maggie, the ILIT will net \$23,000,000 to be used to pay estate tax.

G. Summary:

\*Estate Tax Savings: \$43,500,000

\*Joe and Amy end up with approximately the same amounts with assets of their choosing: \$62 million each

\*Grandchildren receive \$4 million total plus college education is paid

\*Charity receives \$9 million approx.

\*Ample liquid assets to pay estate tax