DFW FPA Conference
February 9, 2023, Irving, Texas

Wealth Preservation and Transfer Strategies for Multi-Generational Families

Presented By:

Jana L. Simons, J.D., LL.M., CFP®

MC MEADOWS COLLIER
ATTORNEYS AT LAW
MEADOWS, COLLIER, REED, COUSINS, CROUCH & UNGERMAN, L.L.P.

901 Main Street, Suite 3700
Dallas, TX 75202
214.744.3700   800.451.0093
fax 214.747.3732
JSimons@meadowscollier.com
www.meadowscollier.com

Presentation Outline

I. General wealth preservation and wealth transfer concepts
II. Partnership planning and discounted entities
III. Dynastic trust planning and grantor trusts
    I. IDGTs
    II. SLATs
    III. GRATs
    IV. ILITs
IV. Charitable planning
V. Plan review and maintenance

Judge Learned Hand

(1872-1961)

"Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands."

– Judge Hand, in *Gregory v. Helvering*, 69 F.2d 809, 810 (2d Cir. 1934), aff'd, 293 U.S. 465, 55 S.Ct. 266 (1935)

Wealth Transfer, Generally

- Wealth transfer through 2045 is expected to reach nearly $85 trillion, of that,
  - ❖ Over $72 trillion will be transferred to heirs, and
  - ❖ Nearly $12 trillion will be donated to charities.[1]
- Despite the best intentions, family fortunes rarely survive multi-generational transfer.
  - ❖ About 60% of families exhaust their wealth by the second generation and 90% of family fortunes have been depleted by the third generation.[2]
  - ❖ Why? Insufficient planning and proactive measures, lax oversight, spendthrift descendants, *estate taxes*, poor investment returns, inflation erosion, etc.

[1] Cerulli Associates, *U.S. High-Net-Worth and Ultra-High-Net-Worth Markets 2021*, https://www.cerulli.com/reports/us-high-net-worth-and-ultra-high-net-worth-markets-2021.

[2] Bernstein Global Wealth Management Research, *Multigenerational Wealth Management: Getting a Legacy Up*, https://www.alliancebernstein.com/research-publications/cma-created-content/privateclient/pdfs/gettingalegacyup_multigenbb.pdf.

Wealth Transfer, Generally

- Sophisticated wealth preservation and transfer encompasses:
  - ❖ Fundamental planning: including wills, revocable trust, representation documents
    - ➢ Transfer tax v. income tax issues, specifically related to basis adjustment potential
    - ➢ Bypass v. marital trust planning
  - ❖ Partnership planning: discounting, asset protection and management, etc.
  - ❖ Dynastic trust planning: wealth accumulation, *thoughtful* gifting, beneficiary protection, etc.
  - ❖ Transfer tax mitigation and income tax considerations
  - ❖ Charitable planning

Wealth Transfer, Generally

- Once the client has decided to transfer (and accumulate) wealth downstream,
  - ❖ To whom should he make the gift (outright or in trust), and
  - ❖ What should he gift (cash, interests in an entity, etc.)?
- Most importantly, efficient and effective planning takes time.

Current Wealth Transfer Landscape

- Current Transfer Tax Exemptions and Exclusions:
  - ❖ The gift, estate, and generation-skipping transfer tax exclusion amount is $12,920,000 for single individuals or $25,840,000 for married couples in 2023.
  - ❖ The gift tax annual exclusion is $17,000 for 2023.
  - ❖ The gift, estate, and generation-skipping transfer tax exclusion is scheduled to revert (or, "sunset" under the terms of the TCJA) to $5,000,000 on January 1, 2026. The $5,000,000 is indexed for inflation and estimated to be around $7,000,000.
- Anti-Clawback authority applicable to lifetime gifts utilizing "doubled exemption."
- Large valuation discounts available under support from Tax Court and 5th Circuit cases.

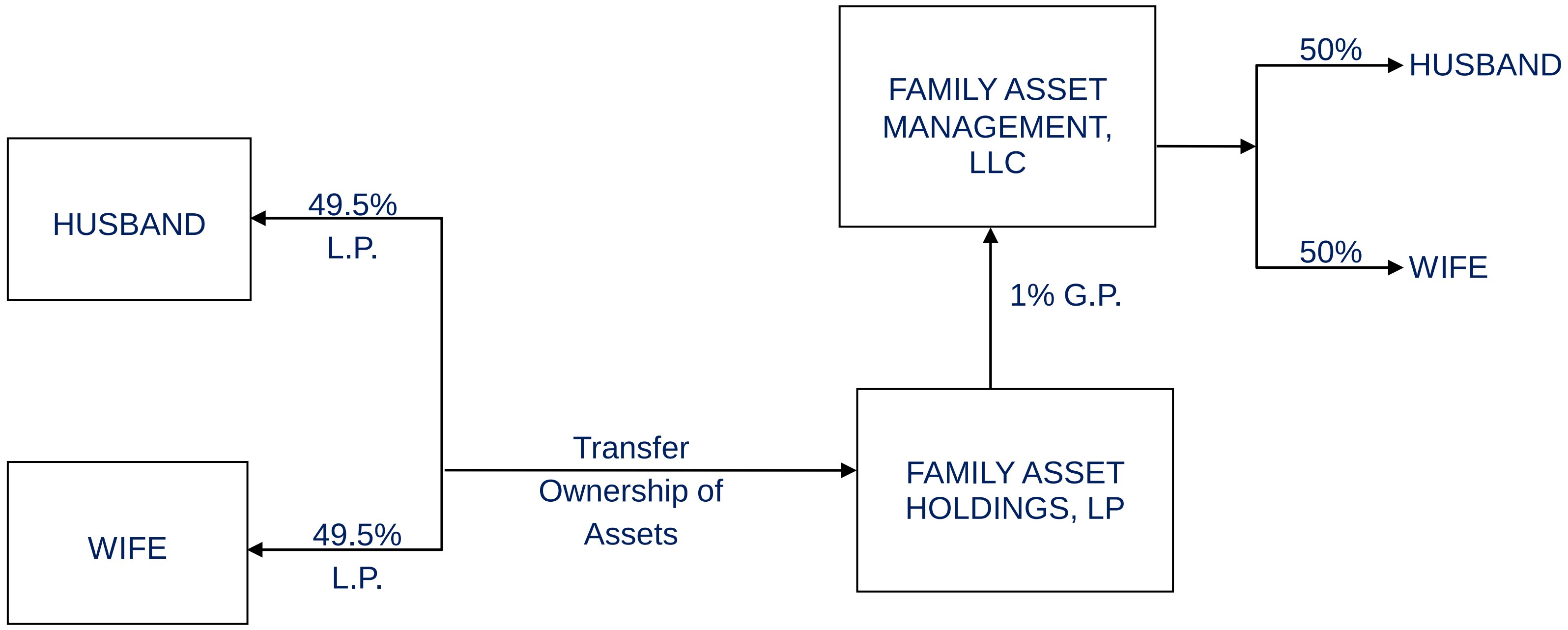
Current Wealth Transfer Landscape

- But, we’ve seen several recent legislative attempts to restrict or eliminate:
  - ❖ Valuation discounts for nonbusiness assets,
  - ❖ Flexibility related to grantor trusts
    - ➢ Inclusion in gross estate of grantor,
    - ➢ Distributions treated as gift,
    - ➢ Termination of grantor trust status considered gift, and
    - ➢ Adjustments for prior gifts.

Popular Planning Techniques

- Gifts/Sales to:
  - ❖ Intentionally Defective Grantor Trusts (IDGTs)
  - ❖ Spousal Lifetime Access Trusts (SLATs)
  - ❖ Irrevocable Life Insurance Trusts (ILITs)
  - ❖ Charitable Trusts (CLTs, CRTs, etc.)
  - ❖ Fully utilize one spouse’s lifetime exemption
- Intra-Family Loans and Refinancing Existing Debt
- Grantor Retained Annuity Trusts (GRATs)
- Use of Discounted Entities
- Upstream transfers (via powers of appointment to achieve basis adjustment – hard to control)
- Grantor trust substitution of low basis assets
- Proceed With Caution:
  - ❖ Reciprocal (Non-Reciprocal) Trusts
  - ❖ Section 678, Beneficiary Defective Income Trust (BDITs)

Family Limited Partnership Basic Structure



Family Limited Partnerships Benefits

- Transfer assets to limited partnership in return for general and limited partnership interests.
- Optional LLC as GP.
- Also applicable to LLC structure; voting/nonvoting LLCs can function similarly.
- Benefits:
  - ❖ Consolidated investment management.
  - ❖ Retained control over investments of partnership.
  - ❖ Asset protection for assets of partnership.
  - ❖ Probate avoidance and confidentiality.
  - ❖ Federal estate/gift tax benefits:
    - ➢ Lack of control discount
    - ➢ Lack of marketability discount

Family Limited Partnerships
Assets

- Assets that should *not* be transferred to FLP:
  - Personal/consumption to a comfortable level,
  - S-corporation stock and tax-deferred accounts, and
  - Assets with a particularly low basis to allow for these assets to realize a basis adjustment at client’s death.

Discounted Entities
Respect and Maintenance

- Discounted Entities under I.R.C. Section 2036:
  - ❖ Most litigated transfer tax issue with almost 40 reported cases in an attempt to ultimately eliminate the discount for restrictions applicable to a limited partnership interest.
  - ❖ Issue is whether assets contributed to an FLP or LLC should be included in the estate of the donor under Section 2036.
- Could apply to FLPs, LLCs, etc.
- Sometimes, discounting is not ideal.

Discounted Entities
Section 2036 Issues

- I.R.C. Section 2036 – Transfers with Retained Life Estate
- General Rule: The value of the gross estate shall include the value of all property, to the extent of any interest therein, of which the decedent has at any time made a transfer (except in the case of a bona fide sale for adequate and full consideration in money or money's worth) by trust or otherwise, under which she has **<u>retained for his life</u>** or for any period not ascertainable without reference to her death or for any period which does not, in fact, end before her death – (1) **<u>the possession or enjoyment of, or the right to the income from, the property</u>**, **<u>or</u>** (2) **<u>the right</u>**, either alone or in conjunction with any person, **<u>to designate the persons who shall possess or enjoy the property or the income therefrom</u>**.

Dynastic Trust Planning with Grantor Trusts

- A Dynasty Trust is an irrevocable trust arrangement designed to benefit several generations of family members and permit lifetime (and/or testamentary) transfers thereto, utilizing the various wealth transfer tax exclusions and exemption limitations.
- Irrevocable trusts structured as "grantor trusts" have long been a staple of wealth transfer planning.
- Structured to hold assets that have either been gifted by the grantor or purchased from the grantor or other party.

Dynastic Trust Planning with Grantor Trusts

- Grantor trusts for income tax purposes.
- Designed to be excluded from the grantor’s gross estate for federal estate tax purposes.
- An integral part of a thoughtful lifetime gifting strategy encompassing:
  - ❖ Annual exclusion gifts,
  - ❖ Transfers utilizing lifetime exemption,
  - ❖ Leveraged transfers in coordination with (discounted) entity planning, and
  - ❖ GSTT transfers.

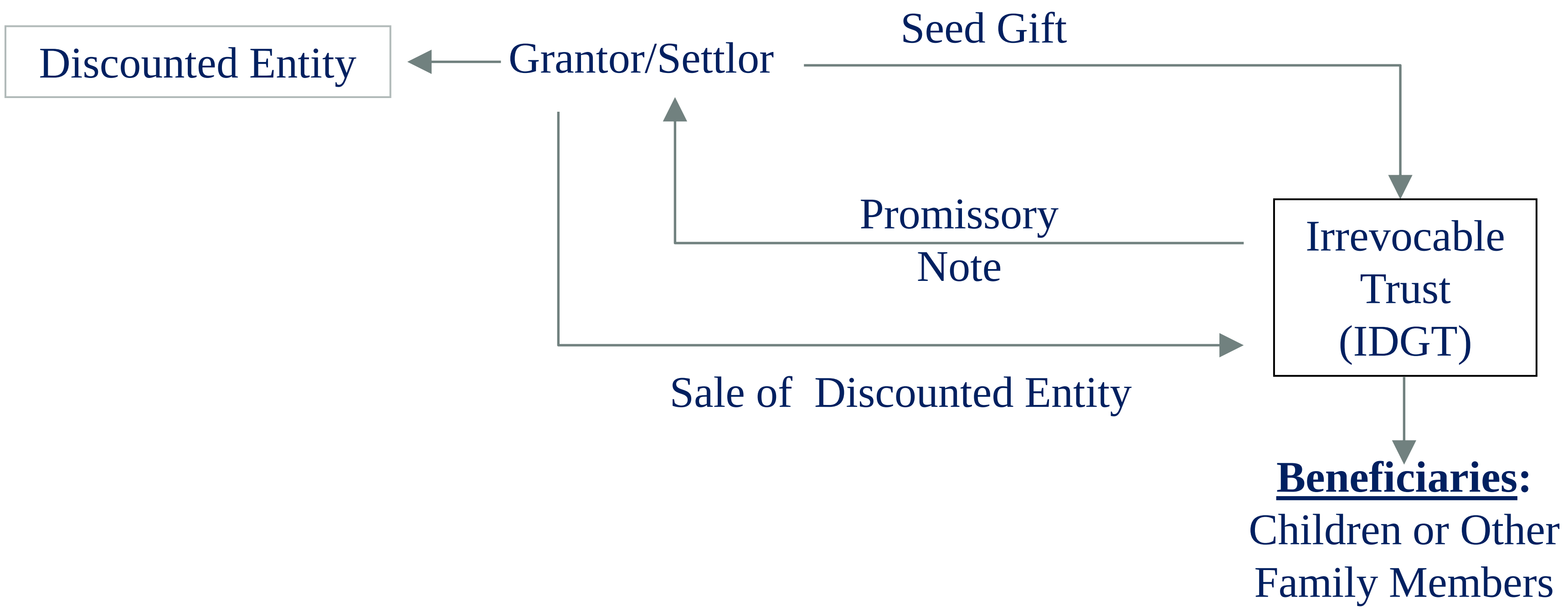
Dynastic Trust Planning with Grantor Trusts

- Grantor trust powers within I.R.C. §§ 673–79 include:
  - ❖ §674 Trustees discretion to name charitable beneficiary;
  - ❖ §675(2) Power of grantor to borrow corpus or income without adequate interest or security;
  - ❖ §675(3) The grantor has actually borrowed from the trust without adequate interest or security and not fully repaid before the beginning of the taxable year;
  - ❖ §675(4)(C) Power held in a non-fiduciary manner by person to reacquire trust corpus by substitute of assets; and
  - ❖ §677 The power to use income to pay life insurance premiums on life of grantor or grantor's spouse.
- Grantor trust status can be terminated.
- Rev. Rul. 2004-64 indicates that the grantor's payment of income tax on behalf of a grantor trust is <u>NOT</u> a gift for federal gift tax purposes.

Intentionally Defective Grantor Trust

- A sale to an Intentionally Defective Grantor Trust (“IDGT") is a popular estate freezing technique.
- The IDGT plan can be diagrammed as follows:

Sale to IDGT


Discounted Entity
Grantor/Settlor
Seed Gift
Promissory Note
Irrevocable Trust (IDGT)
Sale of Discounted Entity
Beneficiaries:
Children or Other Family Members

IDGT Planning

- Structuring sales to IDGTs
  - ❖ Purchase Price - always get an appraisal (might mean multiple appraisals)
  - ❖ Installment Sale - carefully consider the length of the note
  - ❖ Interest Rate - AFR
  - ❖ Develop Economic Model
    - ➢ Understand how income will support note repayment
    - ➢ Understand spending habits of grantor without transferred assets (e.g., is grantor transferring “golden goose?”
  - ❖ Secure the Note

Intrafamily Loans

- Simple intrafamily loans are a good method for older generation to provide the younger generation with capital without making a taxable gift.
- The note must carry (paid or accrued) appropriate interest (at the AFR) to avoid gift tax consequences.
  - ❖ Rates are rising but, intrafamily loan rate minimums are, nevertheless, superior to commercial rates.
- Unpaid interest is deemed interest income by the lender (on which the lender pays tax) and is deemed to have made a gift of that amount to the borrower.

Intrafamily Loan Refinancing

- Refinancing family debt in a low interest rate environment makes perfect planning sense. But refinancing too often may factor into whether the debt is bona fide.
- Any refinancing should consider the following (commercial reasonability):
  - ❖ The fundamentals of the family debt are solid after applying the relevant guidelines; and
  - ❖ There is consideration to the lender to refinance at a lower rate such as:
    - ➢ reduced principal through repayment, shorter maturity date, additional collateral, and/or a faster amortization schedule.
- Note forgiveness is also an option.

Spousal Lifetime Access Trusts

- The Basics:
  - ❖ Completed gift to a trust established for the benefit of a spouse.
  - ❖ Descendants are often included as beneficiaries.
  - ❖ Necessity of partition of community property assets of spouses so one spouse makes gift of separate property.
    - ➢ This could “bankrupt” one spouse!
  - ❖ Designed to be outside the estate of both the grantor and the beneficiary spouse.
  - ❖ Established as a grantor trust for income tax purposes.
  - ❖ Ideally, serves as a “rainy day” fund.
    - ➢ If spouse plans for immediate need/use, consider appropriateness.

Spousal Lifetime Access Trusts

- Advantages:
  - ❖ Spousal access (and control but, this could be a risk, too!);
  - ❖ Particularly useful when planning for medium net worth clients;
  - ❖ Like transfers to many irrevocable trusts:
    - ➢ Payment of income tax liability is not a transfer,
    - ➢ Asset protection,
    - ➢ Ability to allocate GSTT exemption to transfers, and
    - ➢ Ability of Grantor to transact with trust.
- Potential Risks:
  - ❖ Divorce issues:
    - ➢ Completed gift to now-former spouse!
    - ➢ Grantor trust issues – grantor still pays tax post divorce?
  - ❖ Reciprocal trusts prohibited: Steps can be taken to minimize risk of imposition of Reciprocal Trust Doctrine. PROCEED WITH CAUTION – There is no safe harbor.

Spousal Lifetime Access Trusts
Spousal Issues and Considerations

- Issues with exercise of Power of Appointment.
- Distributions to former spouse.
- Powers held by former spouse.
- Gift splitting.

Spousal Lifetime Access Trusts
Reciprocal Trust Doctrine

- The Reciprocal Trust Doctrine (“RTD”) is a judicially created doctrine that identifies the “real” transferor of property by uncrossing interrelated transfers using a substance-over-form rationale, and, therefore, cause inclusion in the transferor’s estate for federal estate tax purposes under I.R.C. §§ 2036–38.
- Example: Husband creates a trust for Wife and names her trustee. Wife creates a trust for Husband and names him trustee.
  - ❖ Result: Applying the RTD results in Husband being the deemed transferor of the trust Wife created and Wife being the deemed transferor of the trust Husband created.

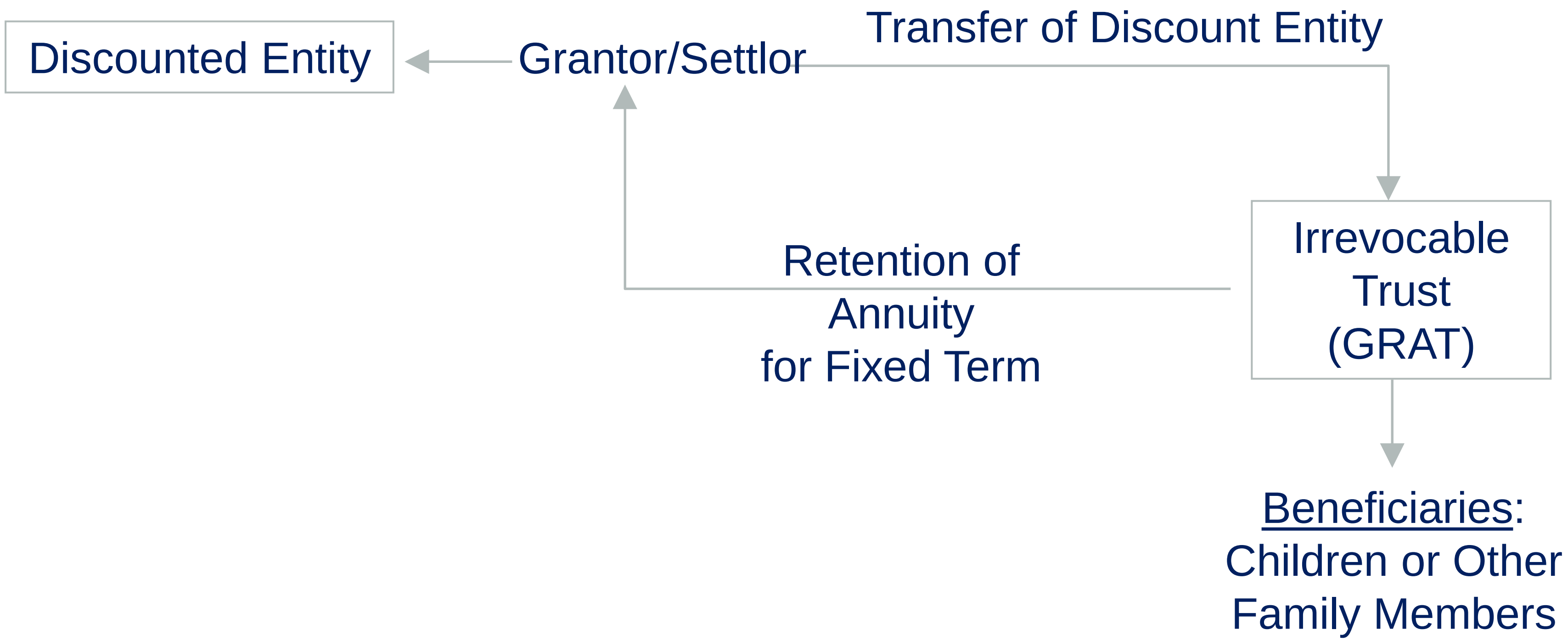
Reciprocal Trust Doctrine Supporting Authority

- *Lehman v. Comm'r*, 109 F.2d 99 (2d Cir. 1940).
  - ❖ Established a 3-prong test
    1. The parties were left in the same economic position they were before the trusts were established;
    2. The trusts were interrelated; and
    3. There was a quid pro quo for the establishment of the trusts.
  - ❖ What does "interrelated" mean?
    1. The similarity of the trust provisions;
    2. The trusts were created at the same time, as part of the same plan;
    3. The trusts had the same trustee; and
    4. The trusts were funded with the same assets.
- *U.S. v. Estate of Grace*, 395 U.S. 316 (1969).
  - ❖ Held that the trusts were reciprocal and a finding of a quid pro quo is not necessary to establish reciprocity. The RTD requires only that the parties be left in the same economic position as they would have been had they created trusts naming themselves as life beneficiaries; and the trusts were interrelated.

Grantor Retained Annuity Trust

- A Grantor Retained Annuity Trust ("GRAT") is a popular and powerful estate freezing technique. In a GRAT, the grantor, transfers an interest in property to a trust and retains an interest in that property in the form of an annuity which meets certain requirements spelled out under Section 2702. The GRAT plan can be diagrammed as follows:

GRAT
Basic Structure



GRAT Planning

- Often used when grantor has no remaining lifetime exemption.
  - ❖ Can “zero-out” the GRAT.
- Utilized when short term appreciation is expected.
- Use of a GRAT as an estate freezing device but GRATs can “fail” if no appreciation to transfer.
- Estate reduction opportunity – Post-GRAT Term.
- GSTT Exemption cannot be allocated until end of annuity term.
- Offset risk with short term rolling GRATs and separate GRAT for each asset.
- Ability to cap the GRAT.
- Use percentage or fraction as payout.

IDGT v. GRAT

- Comparison of GRAT v. Sale to IDGT

	GRAT	IDGT
Survival	Yes	No
Interest Rate	Higher	Lower
GST Allocation	No	Yes
Statutorily Recognized	Yes	No
Seed Gift	No	Yes

Irrevocable Life Insurance Trust

- An irrevocable Life Insurance Trust ("ILIT") is a dynastic trust arrangement that is designed to own life insurance, typically on the life of the grantor(s).
- Designed to escape income and estate taxation on proceeds.
- Avoid "incidence of ownership" to prevent gross estate inclusion.
- Ensure trust is transacting with regard to policy.
- Avoid three-year and transfer-for-value rules.

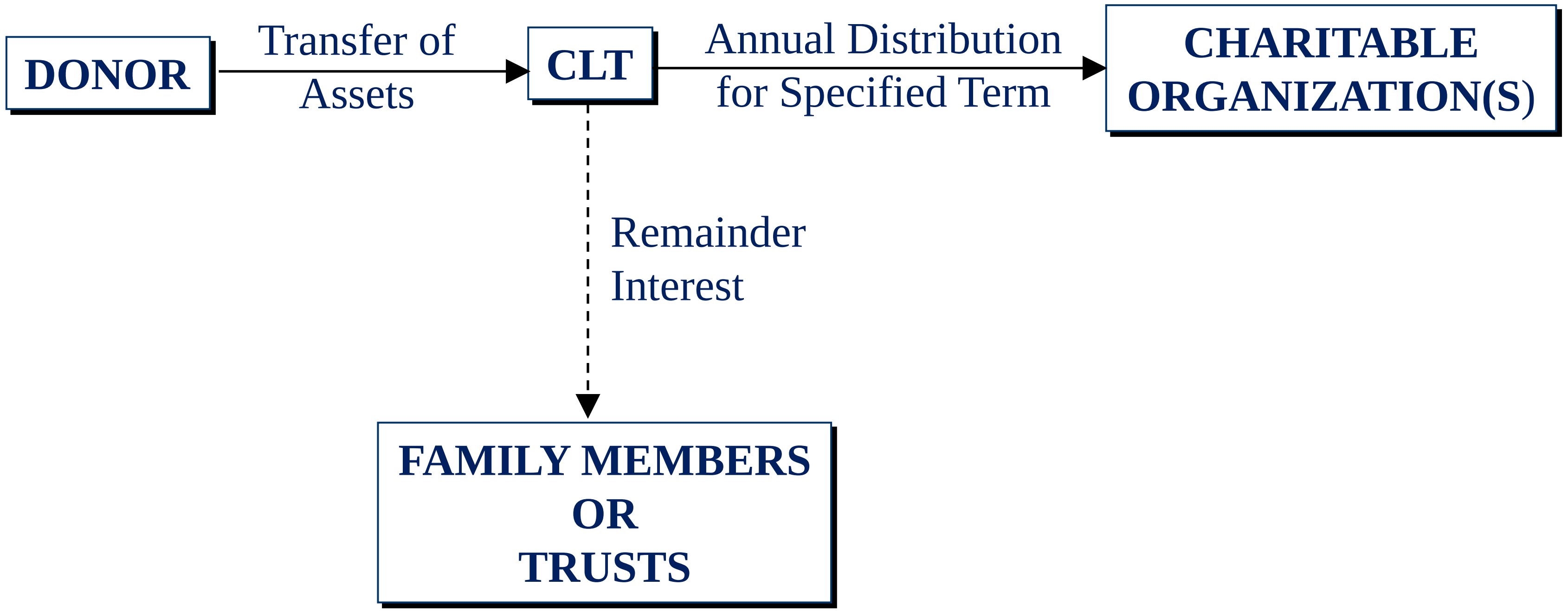
Irrevocable Life Insurance Trust

- Basics:
  - ❖ Grantor insured should have no ability to amend or revoke the trust.
  - ❖ Grantor insured should not have a beneficial interest in the trust and should not serve as trustee.
  - ❖ Prohibit trust estate being utilized to satisfy a legal obligation of the grantor insured.
  - ❖ If a spouse is a beneficiary of Trust, must avoid contribution of community property to Trust.
  - ❖ Take care with respect to separate and community property interests.

Charitable Planning

- Charitable Trusts:
  - ❖ Charitable Lead Trusts (“CLT”) – annuity payments to charity remainder to non-charitable beneficiaries.
  - ❖ Charitable Remainder Trusts (“CRT”) – annuity payments to non-charitable beneficiaries, remainder to charity.
- Donor Advised Funds
- Private Foundations

Charitable Lead Trust



Plan Review, Audit, and Maintenance

1. Obtain a complete and thorough understanding of the client and family, what they'd like to accomplish, the clients' level of sophistication, and potential involvement of the successive generations.

2. Obtain a copy of all current (and prior) planning including, but not limited to, wills, revocable trust, irrevocable trusts, operating agreements for closely held business entities, balance sheets, gift tax returns, etc.

3. In light of everything you now know, is the current planning consistent with their objectives and is additional/different planning appropriate?

   For example, if the client is high net worth, have they used their remaining lifetime and GSTT exemption?

Plan Review, Audit, and Maintenance

- Periodic review is imperative
- Understand flexibility of planning
  - ❖ Power of appointment
  - ❖ Trustee changes
- Stress test existing planning and examination of risk mitigation options, as necessary
- Division of planning might be appropriate
  - ❖ Trust decanting
  - ❖ Partnership division
    - ➢ But, note potential tax consequences!
- Avoid cutting corners on gift and estate tax returns
- Education of successive generations

Plan Review, Audit, and Maintenance

- Fundamental (revocable) estate plan
  - ❖ Do dispositive provision comport with desires?
  - ❖ Are appropriate fiduciaries named?
  - ❖ Verify that the RAP language reflects amended language of Texas Property Code § 112.036.
  - ❖ All family members need a plan!
- Dynasty Trusts
  - ❖ Are transfer documents, income tax returns, and gift tax returns correct and current?
  - ❖ Were gifts adequately disclosed? [Applicable to non-gifts also.]
  - ❖ Was GSTT exemption allocated (either on Form 709 or 706)?
  - ❖ Do transfer documents evidence gifts/sales thereto?
  - ❖ Do returns, transfer documents, and appraisals *all* match?
  - ❖ How are taxes, expenses, and insurance being paid on behalf of the trust?
  - ❖ If a child/descendant (or trust for his benefit) owns an interest, ask: "how did he get that interest and was the transfer adequately disclosed?"

Plan Review, Audit, and Maintenance

- Dynasty Trusts
  - ❖ Maintain balance sheets for trusts.
  - ❖ Is client respecting trust ownership of trust assets?
    - ➢ Is grantor borrowing trust income?
    - ➢ Does grantor have sufficient *other* assets to satisfy income tax liability (if grantor trust)?
  - ❖ Are parents supporting adult children?
  - ❖ Does client have Crummey letters for gifts?
    - ➢ If no Crummey letters, can you establish actual knowledge of gifts by beneficiaries?
  - ❖ Understand the GST plan (and intent) for each trust:
    - ➢ Is the Trust a GST Trust or non-GST Trust?
    - ➢ Have elections been made or was automatic allocation applicable and relied up?
    - ➢ Determine and document inclusion ratio of Trust.
    - ➢ Make appropriate allocations, elections, or take remedial actions now.
  - ❖ Have other elections, such as ESBT/QSST, been made?

Plan Review, Audit, and Maintenance

- Entities
  - Are governing documents, transfer documents, and income tax returns correct and current?
  - Are the entities in good standing?
  - Are the clients respecting the legitimacy of the entities and following corporate formalities and terms of the governing document?
  - Have non-tax purposes for the entity been documented?
  - Does client have books and records for the entity and do the members/partners conduct an annual meeting and prepare minutes?
  - Maintain balance sheets for the entities.
  - How are taxes, expenses, and insurance being paid on behalf of the entity and in whose name are such expenses maintained?
  - If a child/descendant (or trust for his benefit) owns an interest, ask: “how did he get that interest and was the transfer adequately disclosed.” [Following the trail of ownership should not be a challenge!]
  - Do returns, transfer documents, and appraisals *all* match?

Plan Review, Audit, and Maintenance

- Entities
  - ❖ Are there transfer documents evidencing contributions to the entity?
  - ❖ Are there prior sales or other non-gift transactions that have not been disclosed on prior returns?
  - ❖ Have you documented adequate and full consideration for the issued entity interests?
    - ➢ Contribution Schedule
    - ➢ Ownership Percentages
    - ➢ Capital Account Ledgers
  - ❖ Is the client relying on distributions from the entity for personal use (or “living off the partnership”) or is it making disproportionate distributions?
  - ❖ Does the entity own personal use assets or is the client commingling personal assets with entity assets?
  - ❖ Did the client retain sufficient assets for personal support and maintenance?
  - ❖ Does a buy-sell agreement set a value or contain a put or call right?

Anti-Abuse

- Awareness of IRS anti-abuse principles.
  - ❖ Substance Over Form (many overlap under this tax avoidance umbrella) judicial doctrine
    - ➢ Step Transaction
    - ➢ Business purpose
    - ➢ Economic substance
    - ➢ Sham Transaction
    - ➢ Reciprocal Trust Doctrine
  - ❖ Retained enjoyment and control: I.R.C. §§ 2036–38.
  - ❖ Anti-Abuse Regulations to Anti-Clawback provisions targeting QTIP disclaimers, enforceable (unsatisfied) promises to make a gift, transfers typically includable under I.R.C. §§ 2036–38, transfers within 18 months of death, etc.
- Lack of authority for certain planning techniques and inclusion on “no ruling” list.

Jana L. Simons

phone (214) 744-3700
or (800) 451-0093
fax (214) 747-3732
jsimons@meadowscollier.com

Jana represents individuals and multi-generational families. She primarily focuses on tax planning, drafting complex wills and trusts, implementing wealth preservation strategies, and charitable giving. Jana emphasizes helping clients achieve their objectives by designing creative and functional solutions tailored to their specific goals—whether it involves business establishment or reorganization, or facilitating the administration of a trust or estate.

Jana draws from a vast breadth of experience in her law practice. Prior to joining the firm, she managed a large horse ranch and cultivated successful real estate and insurance practices. Jana's business-focused background allows her to understand her clients' concerns and employ a practical approach to tax, estate, and business planning issues.

She holds an LL.M. in Taxation from Georgetown University Law Center with an academic concentration in Estate Planning. During her time at Georgetown, Jana served as an extern for the United States Department of Justice, Tax Division. While working on her J.D., Jana completed her Master's degree in Personal Financial Planning, represented pro bono clients in tax controversy matters with the IRS, served as a Peer Financial Counselor, and clerked for the Honorable Robert L. Jones, United States Bankruptcy Court, Northern District of Texas.

Jana is admitted to practice law in Texas and is a Certified Financial Planner, CFP®.

DISCLAIMER

The information included in these slides is for discussion purposes only, is not legal advice, and should not be relied on without seeking individual legal advice.