Squeeze, Freeze, & Burn: Estate Planning with 678 Trusts

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In addition to serving on the Editorial Advisory Committee for *Trusts & Estates* magazine, Mr. Blum volunteers his time with several non-profit organizations. He is Treasurer of the Fort Worth Symphony, the Multicultural Alliance, and the Texas Cultural Trust. He also serves as Secretary/Treasurer of the Pat & Emmitt Smith Charities and as a member of the Board of Directors of B Sharp Youth Music Program, Inc.

Mr. Blum earned his BBA (Highest Honors) in Accounting from The University of Texas and received his law degree (High Honors) from The University of Texas School of Law.

What is Squeeze, Freeze, & Burn?

- Squeeze, Freeze, & Burn is a highly-effective technique to reduce or even eliminate the estate tax.
  - "SQUEEZE" down the value of the assets.
  - "FREEZE" the value of the taxable estate.
  - "BURN" down, or spend, the money remaining in the taxable estate.
- By utilizing a 678 Trust (also called a Beneficiary Defective Trust or "BDT") in the "freeze" stage, **the client does not have to give up control of the assets or give up access to them.**

Consequences of Doing No Planning

- George and Sarah had a high net-worth, with a very illiquid estate of investment assets worth $75 million and $10 million of other assets (home, bank accounts, cars, personal assets).
- When they both unexpectedly die in an accident, the IRS sent their children a tax bill for over $25 million.

Investment Assets	$75,000,000
Other Assets	10,000,000
Total Assets	85,000,000
Less Estate Tax Exemption x 2	(22,360,000)
Taxable Estate	62,640,000
x 40% Estate Tax Rate	**$25,056,000**

Let's Rewind the Clock

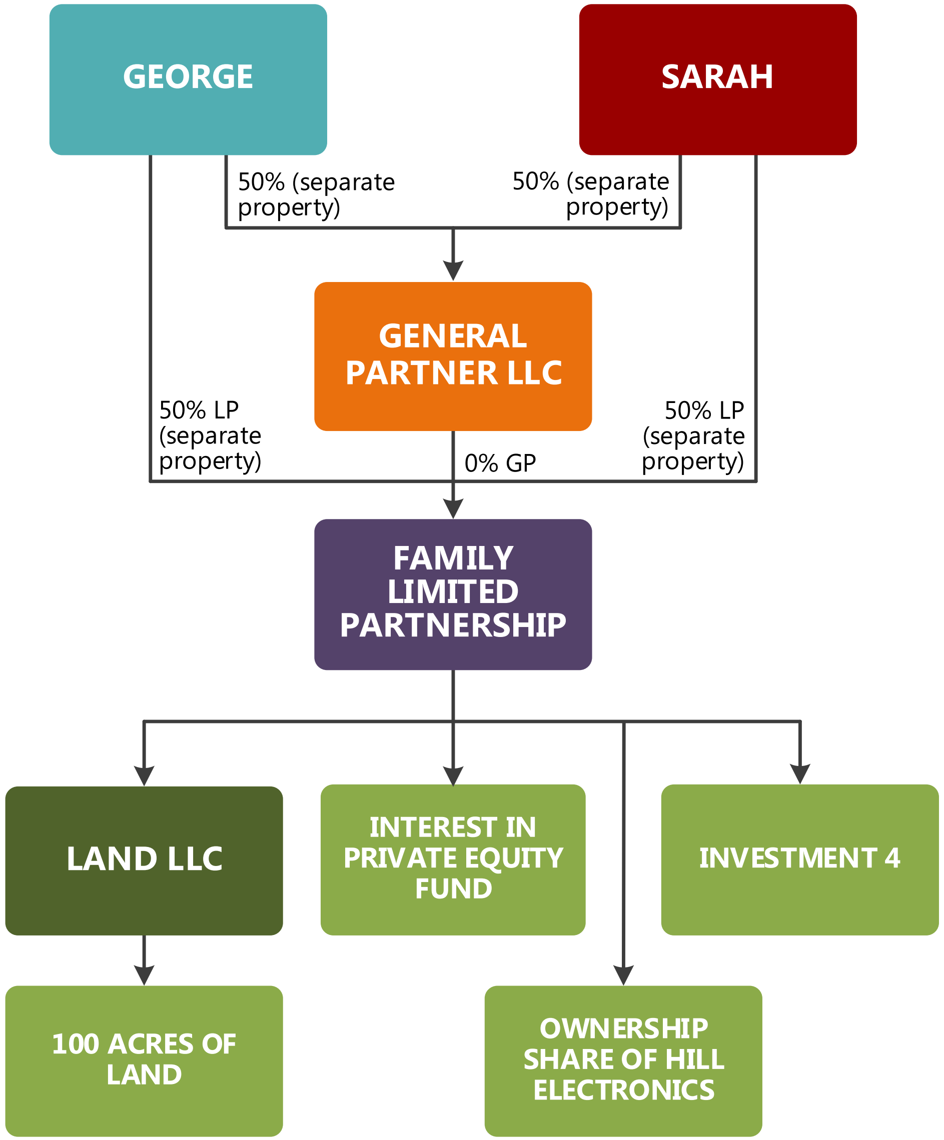
- George and Sarah came to us several years ago to help prepare an estate plan.
- At the time, their investment assets were worth $60 million, and they had other assets worth $10 million (home, bank accounts, cars, personal assets).

Stage 1:
A Family Limited Partnership to “Squeeze” Down the Value of the Assets

- Limited partnership interests are less marketable than assets held outright or assets traded on an exchange, such as stock of public companies or bonds.
- By virtue of the partnership form and standard restrictions in partnership agreements, a partnership interest is worth less than the underlying assets of the partnership.
- For minority, non-controlling interests, discounts for lack of marketability and lack of control are routinely recognized by the courts when the partnership is formed and maintained properly.
- For example, if a partnership is formed and funded with $1,000,000 in investment assets, the limited partnership interests associated with such assets might be valued at only $650,000 (representing a 35% discount for lack of marketability and lack of control).

- Create a structure that qualifies for the best possible valuation discount.
  - If it's a limited liability company or limited partnership, examine the agreement to ensure the entity will qualify for an optimum valuation discount.
  - If it's a C Corporation, transfer the stock to a limited partnership.
  - If it's an S Corporation, reorganize the structure to establish voting and non-voting shares. Then, perform tax planning with the non-voting shares, which could qualify for a valuation discount.

- George and Sarah put their investment assets into a family limited Partnership (“FLP”) with a limited liability company (“LLC”) as the general partner.
- George and Sarah are the initial limited partners of the FLP, and they each own 50% of the LLC.
- Notice that they put an LLC “wrapper” around the real estate they owned outright before putting the real estate into the FLP to provide an extra layer of protection around a risky asset.



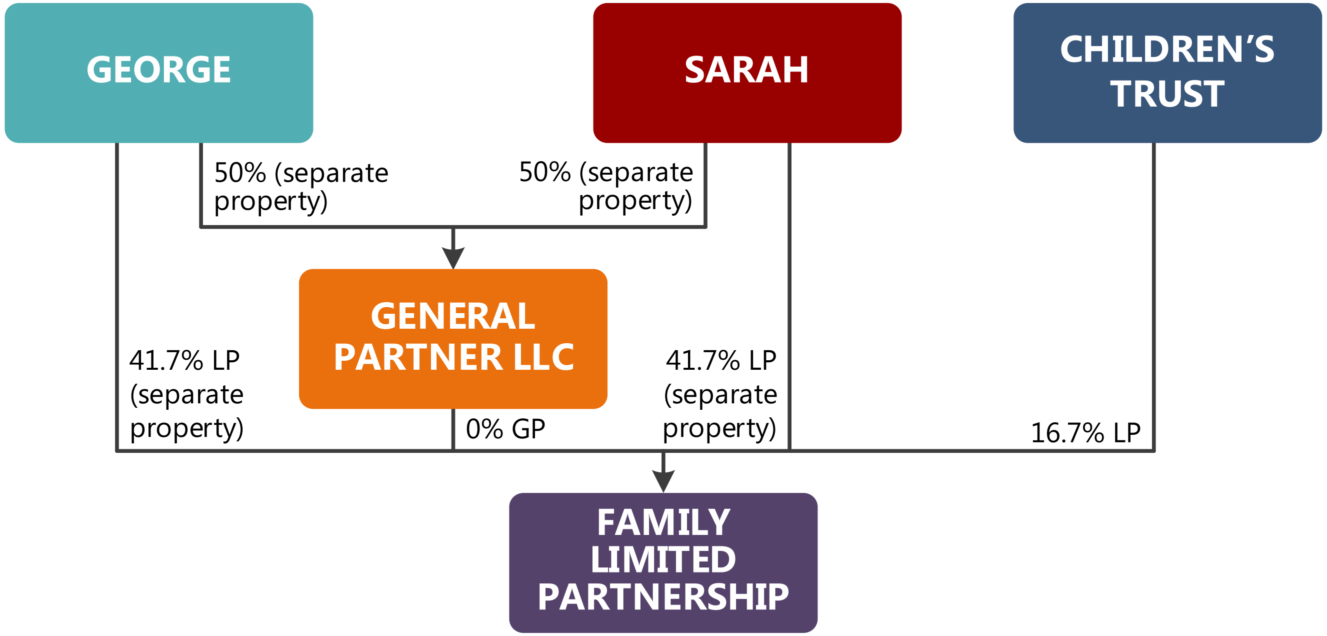
Stage 2:
A Grantor Trust for the Children Begins the "Freeze"

- “Freeze” planning involves gifting and/or selling the limited partnership interests **to a trust which is outside of the estate for estate tax purposes,** such as an Intentionally Defective Grantor Trust, a 678 Trust, or a Spousal Lifetime Access Trust.
- George and Sarah chose to create an Intentionally Defective Grantor Trust to benefit their children (the “Children’s Trust”) and fund it by making gifts to the trust using a portion of each spouse’s lifetime gift tax exemption and GST tax exemption.
- With the trust structured as a grantor trust, the gift is “supercharged” because the grantors (George and Sarah) remain liable for the income tax attributable to the trust and pay the trust’s income taxes out of their own funds. This allows the trust assets to grow without being depleted by income taxes.
- The grantor trust status can be “toggled” off later if the client no longer wishes to bear the trust’s income tax liability.

- As beneficiaries of the Children's Trust, George and Sarah's children and their descendants would be entitled to distributions from the trust as necessary for their health, education, maintenance, and support ("HEMS") needs.
- At a child's death, he or she can be given a special power of appointment to direct the disposition of remaining trust assets.
- By George and Sarah allocating GST exemption to their gifts, the assets in the trust can pass free of estate taxes from generation to generation so long as law allows.
- The assets in the trust are also protected from the children's creditors and any divorcing spouses.

- George and Sarah gift ⅙ of their FLP interests to fund the Children's Trust, resulting in a gift of $3,250,000 from each of George and Sarah.

Underlying Assets	$60,000,000
Less Valuation Discounts of 35%	(21,000,000)
Value of FLP	39,000,000
Value of 1/6 of FLP Interests	**$6,500,000**



Disclosing the Gifts to the IRS

- George and Sarah file Gift Tax Returns (Forms 709) to disclose the gifts.
- The IRS has 3 years from the date a Gift Tax Return is filed to challenge the valuation. Once the 3-year statute of limitations has run, the IRS can no longer challenge the valuation. (Note: The statute of limitations is 6 years if the value omitted is over 25% of the reported gifts.)
- For the statute of limitations to begin, the disclosure must meet the requirements of Treasury Regulations Section 301.6501(c)-1(f)(2) for "adequate disclosure" which includes a copy of the trust agreement, the trust's EIN, the identities and relationship of the transferor and transferee, a description of the property, any consideration received in return, and a <u>detailed description of the method and financial data used</u>.
- In place of the detailed description of the method and data used, an appraisal report can be attached to the Gift Tax Return.

Stage 3:
“Freeze” the Rest of the Family Limited Partnership

- How do George and Sarah move the remaining ⅚ of the FLP out of their estates?
  - They sell it to a 678 Trust.

- Why did they chose a 678 Trust?
  - George and Sarah can remain in control.
  - George and Sarah can be beneficiaries of the 678 Trust and can continue to have access to the assets for their needs.
  - The assets in the 678 Trust are not taxed in George and Sarah's estates.
  - George and Sarah can have a special power of appointment to direct where the assets pass upon their deaths.
  - The assets in the 678 Trust are protected from creditors.

678 Trust Basics

› A 678 Trust is established by a third party (such as the client's parents, sibling, or close friend) with a gift of $5,000.

› The client is the primary beneficiary of the 678 Trust and can receive distributions for HEMS needs.

› With careful drafting, the client may also be named as trustee of the 678 Trust.

› The client-beneficiary is given a withdrawal right over the initial $5,000 contribution.

› The trust agreement provides that a Special Trustee has the power to terminate the trust in favor of the client-beneficiary, even after the client-beneficiary's withdrawal right over the $5,000 gift lapses.

› The 678 Trust technique works because of a "disconnect" between the income tax code and the estate tax code.

Income Tax Code

- IRC Section 678(a)(1) provides that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself.
  - In our trust, when the client-beneficiary is given a withdrawal right over the $5,000 gift, the client-beneficiary becomes the owner of that portion of the trust for income tax purposes so long as the power remains outstanding.
  - Since the withdrawal right applies to all of the assets owned by the 678 Trust, the **entire trust is treated as owned by the client-beneficiary for income tax purposes.**

- Once the withdrawal right lapses, the client-beneficiary may continue to be the owner of the trust for income tax purposes under Section 678(a)(2).

  > "A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof."

  - This means that the client-beneficiary will be treated as the owner of the 678 Trust for income tax purposes if

    (i) The client-beneficiary had a withdrawal right over trust assets that was partially released (or lapsed) and

    (ii) The client-beneficiary would be treated as the owner under Sections 671-677 if the client-beneficiary were the grantor of the trust.

- If our client-beneficiary were the grantor, he would be treated as the owner under Section 676. Under Section 676, a grantor shall be treated as the owner of the trust for income tax purposes if the grantor or a non-adverse party has the power to terminate the trust in favor of the grantor.
- Our Special Trustee, a non-adverse party, has the power to terminate the trust in favor of the client-beneficiary.
- Therefore, our client-beneficiary remains the owner of the 678 Trust for income tax purposes, even after the withdrawal right lapses.

› The client-beneficiary will be responsible for reporting the income generated by the trust's assets on his income tax return. This allows the assets in the 678 Trust to grow without being diminished by income taxes.

› And, this sets the stage for the client-beneficiary to sell assets to the 678 Trust and not have to report any gain.

Estate Tax Code

- If the client-beneficiary is considered the owner of the 678 Trust for income tax purposes, does that mean the 678 Trust's assets are included in the client-beneficiary's estate for estate tax purposes?
  - Under IRC Sections 2041 (relating to estate tax) and 2514 (relating to gift tax), the exercise or **release** of a withdrawal power is deemed a transfer of the property by the person holding the power. As such, the property would be includable in the person's estate.
  - In our situation, our client-beneficiary allowed a withdrawal right to **lapse**. The question is: Is that "lapse" considered a "release"?
  - Sections 2041(b)(2) and 2514(e) provide that a lapse of power is indeed considered a release of such power unless the property which could have been withdrawn does not exceed the greater of $5,000 or 5% of the trust assets (the "5 and 5 exception").
  - For our trust, the withdrawal right is limited to $5,000, so it meets the 5 and 5 exception. For estate tax purposes, there was no release and no transfer of property. Therefore, the property is not includable in the client-beneficiary's estate if the trust is properly drafted.

- In order for the 678 Trust technique to work as intended, it is crucial that the client-beneficiary not be given a withdrawal right exercisable with regard to any other trust at any earlier point in the year of the gift.
  - The 5 and 5 exception is cumulative for each calendar year, so a withdrawal right over a gift earlier in the same year to the same beneficiary could eat into the 5 or 5 calculation.
  - For example, a withdrawal right over a $5,000 gift in January to an Irrevocable Life Insurance Trust ("ILIT") could use up the entire $5,000 amount, so a later gift that same year to a 678 Trust might not meet the 5 and 5 exception.
  - A remedy would be to include "hanging powers" language in the 678 Trust, so the withdrawal right would not lapse until a later year when there is sufficient space under such year's 5 and 5 exception.

Lapse Versus Release

- Sections 2041 and 2514 refer to a lapse of a withdrawal right, but Section 678(a)(2) refers to a partial release of a withdrawal right as the triggering event.
- Is a "lapse" of a withdrawal right considered a "partial release" under Section 678?
- Although the terminology is not exactly mirrored, the IRS has issued a private letter ruling interpreting a lapse under Sections 2041 and 2514 to be a partial release under Section 678. [PLR 200949012]
- In addition, the IRS has implied in prior private letter rulings that a lapse under Sections 2041 and 2514 would have the same effect of a partial release under Section 678. [PLRs 200747002, 200104005, 200147044, 200022035, 9809005, 8342088]

Recap: The "Disconnect"

- For estate and gift tax purposes, when the client-beneficiary allows the withdrawal right to lapse, the client-beneficiary **is not viewed** as the grantor of the trust because of the 5 and 5 exception in the estate tax code, and so the **trust assets are not includable in the client-beneficiary's estate.**

- For income tax purposes, when the client-beneficiary is given the withdrawal right and when the withdrawal right lapses, the client-beneficiary **is viewed** as the grantor of the trust, making the client-beneficiary **the owner of the trust for income tax purposes.** (Note: Although the withdrawal right is limited to $5,000, there is no 5 and 5 exception in the income tax code.)

Ideal Situations for a 678 Trust

› A 678 Trust can be a useful tool for:

- Clients who are starting a business, are expanding a business, or are expecting to purchase an asset that has appreciation potential such as buying a new business opportunity, engaging in additional drilling operations, or making an investment that has substantial upside;
- Clients who have existing assets that have appreciation potential or that are valued at a discount, such as a portfolio of investments owned by an FLP; and
- A closely-held business owner who might be presented with an opportunity to sell the business at some point in the future.

678 Trust Structure

› Structure the 678 Trust to be a GST-exempt dynasty trust.

- When the initial $5,000 gift is made to the 678 Trust, the third-party who makes the gift should file a Gift Tax Return allocating GST exemption to the gift.
- After the initial $5,000 gift to the 678 Trust, no other assets are gifted to the trust. All future transfers to the trust are done by sales for fair market value.
- Because all assets gifted to the trust are covered by the third-party donor's GST exemption, the trust is fully GST-exempt. Therefore, the 678 Trust's assets can pass to future generations free of transfer taxes, including estate tax at the death of the client-beneficiary or the children of the client-beneficiary.

- If our client-beneficiary is going to be trustee of the 678 Trust, does that make the trust assets reachable by the client-beneficiary's creditors?
  - Some states, such as Texas, protect the assets from creditors if the client-beneficiary's distributions are limited to an ascertainable standard.
  - Texas Trust Code Section 112.035(f)(1)(A) provides that a beneficiary is not treated as a settlor of a trust merely because the beneficiary has the power to "consume, invade, appropriate, or distribute property to or for the benefit of the beneficiary if the power is limited by an ascertainable standard, including health, education, support, or maintenance of the beneficiary."
  - Therefore, if the client-beneficiary serves as trustee, include a HEMS standard, not only to prevent the trust from creating a general power of appointment which would cause the assets to be taxed in the client-beneficiary's estate, but also to protect the trust assets from creditors.
  - If extremely concerned about creditor reach or if not in Texas, an option is to use an independent trustee. If using an independent trustee, the distributions could be purely discretionary (not limited to an ascertainable standard).

- Does giving the client-beneficiary a withdrawal right expose the trust assets to the reach of creditors?
  - In some cases, giving a beneficiary a withdrawal right could make a "spendthrift trust" into a "self-settled spendthrift trust" with no protection against the beneficiary's creditors.
  - However, some states (such as Texas) include a 5 and 5 exception in their trust laws, protecting trust assets from creditors as long as the value of the property which could have been withdrawn does not exceed the greater of $5,000 or 5% of the trust assets. [See Texas Trust Code Section 112.035(e).]
  - To protect the 678 Trust assets from creditors, choose a state that provides such a 5 and 5 exception.

Drafting Options

› The 678 Trust can be drafted to, upon the clients' deaths, pour into an existing trust for the children's benefit or divide into separate trusts for the children.

› The 678 Trust can also be drafted to allow the client-beneficiary to exercise a special power of appointment ("SPOA").

- An inter vivos SPOA can give the client-beneficiary the power to provide for trust property to pass to individuals or charitable organizations during the client's life.
- A testamentary SPOA can give the client-beneficiary the power to control how the property will be distributed at death.
- The SPOA must be drafted so that assets cannot be appointed to the client-beneficiary, the client-beneficiary's estate, or the creditors of either.

Moving Assets Into the 678 Trust

- To move assets into the 678 Trust, the client-beneficiary sells assets to the 678 Trust in exchange for a promissory note. No gifts should be made to the 678 Trust beyond the initial $5,000 gift contributed by a third party. Any additional gifts could alter the income tax and estate tax characteristics of the 678 Trust.
- It is important that the sale be structured so that it will be respected by the IRS as a bona fide sale under IRC Section 2036.
- The sales price must be equal to the fair market value. If the IRS later determined the sales price was lower than the fair market value, the IRS would argue that the difference was a gift. Sale documents should include adjustment clauses to guard against such an unintentional gift.
- The interest rate on the promissory note should be at least equal to the applicable federal rate for the type and length of the loan.

- The 678 Trust needs to have sufficient substance to support the sale.
  - If the 678 Trust has not yet built up significant value, it can have other trusts or individuals (other than the client-beneficiary) guarantee the note owing to the client-beneficiary in exchange for a guarantee fee.
  - The assets pledged should equal at least 10% to 20% of the size of the promissory note (the higher, the better).
  - In order to avoid an unintentional gift to the 678 Trust by the guarantor, the 678 Trust needs to pay the guarantor an annual guarantee fee that would be comparable to the fee charged by an unrelated guarantor. The fee would continue to be paid each year until the promissory note is paid in full.
  - The rule of thumb we use to value the guarantee fee is 3% of the amount of assets pledged.
  - For example, if the assets pledged equal 20% of the size of the note, the guarantee fee would be 60 basis points of the size of the entire note (or, the size of the note multiplied by 0.006.)

George and Sarah's 678 Trust

- George's brother, Jim, created a 678 Trust to benefit George and Sarah and their descendants and funded it with a $5,000 gift.
- George and Sarah sold their remaining ⅚ FLP interest and all of their LLC interest (the general partner) to the 678 Trust and each received a 9-year promissory note for $16,250,000 in return, plus interest at the mid-term applicable federal rate.

Underlying Assets	$60,000,000
Less Valuation Discounts	(21,000,000)
Value of FLP	39,000,000
Value of 5/6 of FLP Interests	**$32,500,000**

- The Children's Trust had sufficient assets to pledge as the guarantor of 20% of the promissory note amounts.
- In return for the guarantees, the 678 Trust executed guarantee fee agreements agreeing to pay the Children's Trust annual fees equal to 3% of the amount guaranteed.
- The annual guarantee fees paid by the 678 Trust to the Children's Trust are $195,000.

Promissory Notes	$32,500,000
Guaranteed Portion	x 20%
	$6,500,000
Guarantee Fees	x 3%
	$195,000

Disclosing the Sale to the IRS

- The $5,000 gift-maker should file a Gift Tax Return to disclose the gift and to allocate $5,000 of their GST exemption to the gift.
- The client-beneficiary should file a Gift Tax Return to disclose the sale.
- Why would you want to disclose a transfer that's not a gift?
  - Disclosing the sale on a Gift Tax Return starts the 3-year statute of limitations during which the IRS can challenge the valuation.
- Doesn't disclosing the sale just bring the transfer to the IRS's attention? If the IRS doesn't know about the transfer, how can they challenge the valuation?
  - The transaction will have to be disclosed at some point, assuming the client's estate will be required to file an Estate Tax Return (Form 706). Part 4, Question 13e asks if the decedent transferred or sold an interest in a partnership, LLC, or closely-held corporation to a trust under which the decedent possessed any power or beneficial interest. Without the statute of limitations running, the IRS could challenge the valuation at any time.

- How do you disclose a sale transaction on a Gift Tax Return?
  - Attach a statement to the Gift Tax Return electing to disclose a non-gift completed transfer pursuant to Treasury Regulations Section 301.6501(c)-1(f)(4);
  - Indicate why the transfer does not constitute a gift; and
  - Include all the information required to adequately disclose a gift.
- The appraisal report already obtained for the earlier gifts can be used to value the assets sold.
- The appraisal value sought should be on the mid-range of the scale of reasonableness. If the appraisal is too aggressive and results in a value lower than that reasonably determined by the IRS, it is possible that the client will be treated as having made a gift to the trust equal to the difference between the appraised value and the IRS-determined value.
- Hiring a qualified appraiser and obtaining a top-quality appraisal report to attach to a Gift Tax Return is money well spent.

- George and Sarah file Gift Tax Returns disclosing the sale.
- If George and Sarah were to die after the investment assets have appreciated from $60 million to $75 million (but before the promissory notes were paid down), the estate tax would be $10,656,000.

Promissory Notes	$32,500,000
Other Assets	10,000,000
Total Assets	42,500,000
Less Remaining Exemptions	(15,860,000)
Taxable Estate	26,640,000
x 40% Federal Estate Tax Rate	**$10,656,000**

Estate tax with no planning: $25,056,000

Estate tax with Squeeze & Freeze: $10,656,000

Stage 4:
“Burn” Down the Remaining Assets Subject to Estate Tax

- George and Sarah use the assets that remain in their taxable estate for their living expenses and to pay the income taxes generated by the Children's Trust and the 678 Trust.

- As the note payments are "burned" down in order to provide George and Sarah with cash to pay living expenses and income taxes, the estate tax savings will be even greater.

- After the notes are paid off, the trustee of the 678 Trust will make distributions to George and Sarah under the HEMS standard to cover their living expenses and income taxes.

Results After
Squeeze, Freeze, & Burn
with a 678 Trust

"Tax Fence" With No Planning

ASSETS INSIDE ESTATE
Subject to 40% Estate Tax
and Creditor Claims

PERSONAL ASSETS
(HOUSEHOLD ITEMS, BANK ACCTS, ETC.)

PERSONAL RESIDENCE
(PROTECTED FROM CREDITORS)

INVESTMENTS

RETIREMENT ASSETS
(PROTECTED FROM CREDITORS)

TAX FENCE

ASSETS OUTSIDE ESTATE
Protected from 40% Estate Tax
and Creditor Claims

“Tax Fence” With Planning

ASSETS INSIDE ESTATE
Subject to 40% Estate Tax and Creditor Claims

PERSONAL ASSETS
(HOUSEHOLD ITEMS, BANK ACCTS, ETC.)

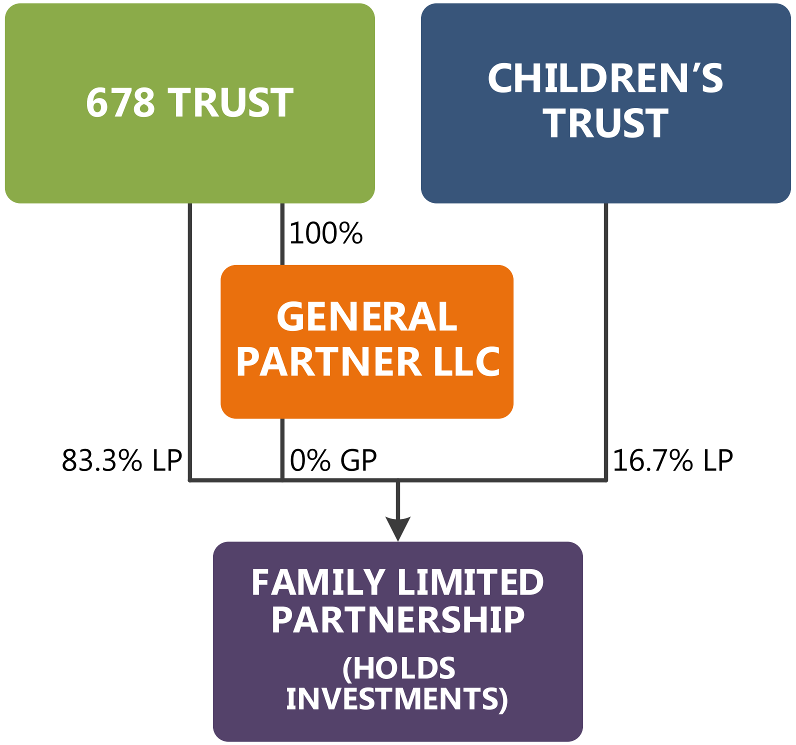
PERSONAL RESIDENCE
(PROTECTED FROM CREDITORS)

NOTES RECEIVABLE
(SPEND DOWN BY USING FOR LIVING EXPENSES AND PAYMENT OF INCOME TAXES)

RETIREMENT ASSETS
(PROTECTED FROM CREDITORS)

TAX FENCE

ASSETS OUTSIDE ESTATE
Protected from 40% Estate Tax and Creditor Claims



Consider Additional Planning

› Note that the notes receivable are reachable by creditors until paid off. Consider engaging in additional asset protection planning with the notes to protect them from creditors.

› A client can do multiple sales to the same 678 Trust. If additional assets build up in the estate, do another sale to the same 678 Trust.

Benefits Over Other Freeze Planning Techniques

- The client doesn't have to give up access to the assets or control of the assets.
  - George and Sarah could have sold their remaining ⅚ of the FLP interests to the Children's Trust. This would have effectively transferred future appreciation out of their taxable estate, but George and Sarah would have lost access to the funds generated by the investment assets once the promissory notes were paid in full.
- The client doesn't have to survive the transaction with the 678 Trust by any period of time in order to move assets out of the client's estate, such as with a grantor retained annuity trust ("GRAT").
- Unlike with the Children's Trust or a GRAT, the terms of the 678 Trust can be modified by the client by a testamentary SPOA, allowing the client to account for changes in circumstances or a change in the law.

- Unlike with a GRAT, the estate tax inclusion period ("ETIP") rules do not apply, so GST exemption can be allocated at the creation of the 678 Trust, and it only needs to be allocated to the $5,000 gift in order for the entire trust corpus to be GST exempt.
- Unlike a GRAT where the grantor cannot add new assets to it after inception, the client-beneficiary can make additional future sales to the same 678 Trust.
- Assets in the 678 Trust do not constitute marital property, protecting the assets if a beneficiary of the 678 Trust gets a divorce.

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