

**24TH ANNUAL ADVANCED PERSONAL FINANCIAL
PLANNING CONFERENCE**

**PRACTICAL STRATEGIES AND SYNERGIES
FOR TODAY'S ESTATE PLANNING**

By

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PRACTICAL STRATEGIES AND SYNERGIES FOR TODAY'S ESTATE PLANNING

I. INTRODUCTION

A. Asked to present on “current techniques” but not on the basis of an isolated explanation of this specific and particular technique.

B. Instead, asked to present “real world” situations in which combinations of techniques are employed to achieve (more or less) the full “solution” to the client’s planning goals.

C. Asked to highlight examples of common planning situations in which the techniques work in concert to achieve “synergy”.

D. “Synergy”: the interaction of two or more agents or forces or conditions, so that their combined effect is greater than the sum of their individual effects. (From the Greek: “sunergia”, meaning “cooperation”; or from “sunergos”, meaning “working together.”)

E. The following six synergies are organized generally from the less complex to the more complex, and/or from the less aggressive to the more aggressive.

F. All of these six synergies are “practical” in the sense that real clients in the real world have actually decided to employ these synergies, in terms of assisting them to attain their estate planning and business succession planning goals.

II. SYNERGY #1: Template for Family Business Succession

A. General Context: Problem and Opportunity. Family-owned closely held business. Mom and Dad and their Children. The goal of Mom and Dad is to pass the business to the children. Synergy #1 is referred to as a **TEMPLATE** because in almost all family business succession situations some version of this solution forms a part of the plan, and in many family situations (particularly the smaller businesses) some version of this solution is an adequate practical solution to the business succession problem. This solution applies where future ownership will be lodged only in children (and perhaps grandchildren), and not at all in Key Employees.

The essence of the template: the business is continued by Gift to Junior and Compensation to Senior.

B. Summary of the template:

(1) the Goal of transfer to children;

(2) the Key Elements of:

- Retirement Planning for Dad and Mom
- Eventually passing Voting Control of the Corporation
- Passing Equity Ownership in the Corporation
- Providing Income Security for Mom and dependent non-active children
- Coping with the Equality Issue as between active children and non-active children
- Addressing the Liquidity Need (if any)
- Minimizing Taxes
- Obtaining a favorable Valuation

(3) the following Techniques are synergized in the template:

- Recapitalization of the Corporation (or LLC) into Voting and Non-voting stock (or equity classes)
- Systematic gift program of Non-voting equity
- Valuation discounts and appraisals
- Trusts for children/grandchildren
- (possible “parallel”) FLP/LLC entity (to help maintain “equality” for Non-active children)
- Buy-Sell Agreement (especially if child predeceases Dad)
- Compensation Contracts for Dad (with continuing benefit for Mom)
- “Classic” estate planning involving a Marital Trust for Spouse and Durable Powers of Attorney
- Irrevocable Life Insurance Trust owning joint and survivor life insurance to address liquidity need
- At the “appropriate” time, transfer of Voting Stock to Active Child/Children

C. Systematic Gift Program During Life.

- (1) First, recapitalize (“recap”) the corporation.
 - (a) Recap into voting common stock and non-voting common stock. (Not a preferred stock recap pursuant to Section 2701.)
 - (b) Separates management control (voting common stock) from equity ownership (non-voting common stock).
 - (c) Section 368(a)(1)(e) provides that this recap is income tax free.
 - (d) Need special Board of Director and Shareholder Consent. File “Articles of Amendment” with state agency to amend the corporate charter.
 - (e) Not document intensive; no advance IRS ruling needed.
 - (f) Five percent of the total equity is allocated to Class A voting common stock; 95% to Class B non-voting common stock.

Example: \$4 million stockholder’s equity. 2,000 shares of \$1 par value Class A voting. 38,000 shares of \$1 par value Class B non-voting.
 - (g) The two classes are equal in all respects except for the vote.
 - (h) O.K. for S corporations.

(2) Second, Father and Mother keep the Class A voting common, and systematically give away the Class B non-voting common to their children and grandchildren. Use \$13,000/\$26,000 per year per donee.

Example:

Use it or lose it. 2 children plus 2 spouses plus 4 grandchildren equals 8 X \$26,000, or \$208,000 per year. After 35% discount, that is \$320,000 per year. Over 10 years that is \$3,200,000 in initial real value that has been removed from senior generation estate. At 45% marginal rate, that is a savings of \$1,440,000 in tax plus future income and growth!

(3) Gifts to children and/or grandchildren can be outright, or in trust. Trust is flexible way of administering and holding legal title to the property. Trusts for children have essentially no restrictions on their terms. Trusts for grandchildren either have to use part of the \$2M GST exemption, or the trust has to have special features under Section 2642(c) in order to be exempt from generation skipping transfer tax.

(4) Special trust restrictions for S corporation stock: grantor trust; QSST; or ESBT.

(5) Absolute control is maintained in the hands of the owner of the Class A common stock. Ultimately, the Class A is left only to the child or children who will be in control of the business in the next generation.

(6) Valuation discounts of up to 25-45% (depending on risk tolerance) can be claimed in valuing the gift of the non-voting common. Need expert appraisal.

D. Giving Away the “Unified Credit” During Life.

(1) First, recap the corporation (as above).

(2) Father and Mother use some or all of their \$1,000,000/\$2,000,000 applicable exclusion amount during their lifetime, rather than waiting to use the unified credit upon their demise in their estate.

(3) Gets more future growth out of their taxable estates quicker. Also moves future dividend income out of their estate at no transfer tax cost.

E. Equality Issues in Gift Program.

(1) What if some children are involved in the business and other children are not? Many (but not all) business owners grapple long and hard with issues related to some sense of “equality” when considering the children active in the business versus the children who are not active in the business. This complex problem area has many aspects.

(2) Even if desired, “strict equality” is not really achievable, given differences at least in the timing of gifts to children (gift during lifetime versus gifts at death of estate owner). “Rough equality” tends to be the business owner’s goal, but that takes many forms in accordance with specific value judgments.

(3) How much has the child who is active in the business “earned” the right to receive the business, so as to augment what would otherwise be an equal overall share? Resentment and tensions among children have to be considered. Sometimes the business is asked to support, or help support, a child who is not active in the business.

(4) There is a wide spectrum of possible value judgments by the business owner: at one extreme, the active child receives the business and an equal share of the rest and residue; at the other extreme, all children share equally in the rest and residue, and the value of the business received by the active child counts against her equal share.

(5) Possible differences of opinion between Dad (“My son has earned the right to receive the entire business; plus an equal share of whatever else there is.”); and Mom

("We love all our children equally, and our daughters will not be penalized because they chose the traditional path of marriage [like their Mother did]; all our children will receive an equal share of all the wealth, including the business.")

(6) Use other assets to achieve "equality." This is the classic and best solution. Give Class B non-voting common stock only to the active children (and grandchildren in their line); at the same time give other assets to the inactive children (and grandchildren in their line). Good candidates for "other assets" are limited partnership interests in family partnership, or LLC membership interests in Family LLC, owning real estate leased to business or owning equipment leased to business. "Other assets" can also be non-Company related assets, of course.

(7) Be careful: Do not give away "other assets" that Father and Mother really need for their own economic security. If Father and Mother cannot afford right now to give away "other assets" to inactive child, then make it up to the inactive child later with an "equalization" clause in the Will or Revocable Trust. It doesn't matter, on the other hand, that Father (and Mother) give away Class B non-voting common stock, because control is maintained through the continued ownership of the Class A voting common stock, and that control guarantees favorable compensation arrangements.

(8) Never give even non-voting stock (or equity interest) to Inactive Child or descendants of Inactive Child.

F. Compensation For the Senior Generation.

(1) If Father and Mother give the Company away to family members and do not sell it, how are they "rewarded" for the transfer of the Company?

(2) What is the goal? In the context of a gift program, the goal is not to return the total FMV of the Company to Father and Mother. The "reward" for the parents is seeing the family business continued by the children. The goal, instead, is to make sure that the chosen lifestyle of Father and Mother is secure for the rest of their lives. This goal is achieved by designing the right kind and level of compensation arrangements. The three devices that are typically used are:

- (a) Employment Agreement to cover current employment until retirement, with "salary continuation" features in the event of Father's disability;
- (b) Deferred Compensation Agreement to delay the payment of a portion of a future salary increase, until the years following the Business Owner's retirement (of course, the portion deferred is a pure "extra", and the Business Owner does not actually give up future salary increase; payment of the deferred amount will be made to the spouse if the Business Owner dies during the term of

the payout following retirement) (the payments when received are subject to self-employment tax); and

- (c) Consulting Agreement, whereby Business Owner provides consulting advice after retirement.

(3) Tax consequences for all of these devices are (comparatively) favorable: the payments are deductible to the Company, provided that the total payments are within the bounds of “reasonable compensation”. As a practical matter, the latter concept does not typically restrict to any substantial extent, although it must always be kept in mind.

G. Gift Program Completed On Death.

(1) Class A Stock. There is a very nasty trap if the Business Owner leaves Class A voting common stock outright and not in trust to active children upon Business Owner’s demise, while leaving the rest of the Class B non-voting common stock to the QTIP Marital Trust (so as to supposedly defer all federal estate taxes at the senior generation level until the demise of the survivor of the Father and Mother).

Such a disposition causes an artificial extra federal estate tax to be generated because of the gap between the undiscounted value of the Class B in the Business Owner’s estate when coupled with the control element of the Class A, versus the discounted value of the Class B when it is used to fund the Marital Trust (in a case where the Class A voting stock goes outright to Child.)

Thus, both the Class A and the Class B must pass initially to the Marital Trust.

The Active Child can be Co-Trustee of the Marital Trust with the sole obligation of voting Class A.

After the expiration of the statute of limitations on the Business Owner’s estate administration, the Active Child should purchase the Class A stock from the Marital Trust for FMV as then determined by appraisal. This can be an installment payment over (for example) 14 years with AFR interest. Upon the spouse’s subsequent demise, any remaining Class B stock left in the Marital Trust will be entitled to claim a valuation discount!

The Business Owner’s Will or Revocable Trust should provide that the Class A stock is distributed outright to the Active Child from the Marital Trust upon the subsequent demise of the spouse; this would occur if the Active Child had not yet accomplished the purchase of the stock as mentioned above.

(2) Class B Stock. The QTIP Marital Trust is also written so as to facilitate a continuation during the rest of the Spouse’s life of the systematic gift program involving Class B non-voting common stock. Discretionary distributions of corpus are authorized; Class B non-voting stock is distributed to Spouse; Spouse gifts at the rate of \$12,000 a year to each active

child donee (and to grandchildren in the line of the active child/children, often using Section 2642(c) trusts). Do not “condition” in the text of the QTIP the distribution to the Spouse with the requirement that she in turn re-gift to the active child, etc. This loses the marital deduction.

(3) Upon the Spouse’s subsequent demise, the QTIP Marital Trust terminates and distributes the remaining Class B non-voting common stock either only to active children or to all children, depending on the dynamics of the “equality” issue. If the Class B passes to the inactive child, then in the text of the Will or Revocable Trust, give the Active Child the right to call the same and/or give the Inactive Child the right to put the same.

(4) Liquidity planning must then be coordinated with the imposition of a federal estate tax (FET) on the subsequent demise of the Spouse, where some of the Spouse’s estate for tax purposes (through the QTIP Marital Trust) consists of the remaining Class B non-voting common stock, which was not previously given away.

- (a) Liquidity is most often supplied in this context by an Irrevocable Life Insurance Trust (ILIT), which purchases “hard assets” from the QTIP Marital Trust upon the Spouse’s demise at then FMV. There is no capital gain to the QTIP Marital Trust because the assets have received a step up in basis for income tax purposes equal to the FMV on the date of the Spouse’s demise (or on the date six months after the Spouse’s demise, if the Personal Representative of the estate chooses the “alternate valuation date” for federal estate tax purposes).
- (b) Joint and survivor life insurance (on the lives of both Father and Mother) is often selected as the life insurance product; the proceeds are received when the FET is due.

(6) Again, note the Essence of the template: the entire business has been continued to family members using gifts during life and gifts after death, with no sale of the company to any extent involved. Economic security for Father and Mother has been provided entirely by compensation arrangements.

H. Template Elements.

- (1) Recap using Class A voting common and Class B non-voting common.
- (2) Business Owner keeps the Class A (at least for the time being).
- (3) Use systematic gift program for Class B; use unified credit gift to “jump-start” gift program for Class B.
- (4) Spend the money for a first class appraisal; have the valuation expert opine specifically on the extent of valuation discount when a minority interest of Class B is hypothetically being sold.

- Negotiate up front for “package” consisting of “full-blown” appraisal now, plus approximate cost of annual updates (consisting of, typically, three page letter report) for (say) next 5 years.
- (5) Explicitly address and resolve “equality” problem (if any).
 - (6) Plan compensation and financial security for senior generation. Prepare Employment Contract (with salary continuation features), Deferred Compensation contract, and Consulting Agreement (just before retirement).
 - (7) Redraft Will (or RLT) to bequeath Class A and Class B stock to Marital Trust, with Active Child as Trustee to vote Class A.
 - (8) Discuss with Active Child and with spouse the fact that Active Child will be purchasing Class A from Marital Trust approximately 3-4 years after demise of Business Owner for then FMV, paying for the same over 15 years with an unsecured promissory note. N.B.: Must not separate voting Class A from non-voting Class B on demise of Business Owner (by, for example, bequeathing voting stock to Active Child while leaving non-voting stock to Marital Trust), or else IRS makes “Chenowith”-type argument to generate federal estate tax in Business Owner’s estate despite the marital deduction.
 - (9) Discuss with Spouse his or her “moral obligation” to continue systematic gift program of Class B after death of Business Owner, using stock distributed from QTIP Marital Trust.
 - (10) Prepare Durable Powers of Attorney for Business Owner and Spouse specifically authorizing ongoing gift program.
 - (11) Project and quantify FET liquidity need on second spouse’s death, making reasonable assumptions consistently applied. Draft ILIT. Have trustees buy Joint and Survivor Insurance.
 - (12) Consider Use of Section 2642(c) Trusts for grandchildren to own Class B non-voting stock or to own life insurance.

III. SYNERGY #2: COMPREHENSIVE VALUATION DISCOUNT PLANNING.

A. General Context: Problem and Opportunity. Mom and Dad (Grandfather and Grandmother) want to minimize the eventual federal estate tax burden by using valuation discount planning. They are willing to embark on a longer range plan to achieve that goal.

B. Proposed Solution: Use lifetime valuation discount planning to establish “Family LLC” entity which will eventually “pool its capital” with Mom/Dad in a federal estate tax

valuation discount entity. Use Grantor trust planning and low interest AFR loans to enhance size of Family LLC, in order to justify larger contribution to the “pool” by Mom and Dad.

C. Techniques Synergized:

1. Discounted Gift of Family LLC Membership Interest In Year 1 Using Lifetime Exemption.
2. GST Planning.
3. Perpetual Trust.
4. Grantor trust planning.
5. Low Interest AFR loan.
6. Systematic gift of LLC Membership Interest in Years 1 through 5 using Crummey clause.
7. Creation of “Family Pooling of Capital” entity in Year 6.
8. Valuation Discount Appraisal in Estate of Mom/Dad.
9. Avoiding aggregation in Surviving Spouse’s estate.

D. Phase One: Lifetime Gift:

1. Goal here: Dad and Mom want to keep control of the investment, sale and distribution policies of the LLC during lifetime until formation of the federal estate tax valuation discount entity, and want to obtain a gift tax valuation discount for lifetime gifts.
2. Goal is to give away 100% of the LLC Interest. For example, Dad and Mom are rich enough, and economically secure enough, to give away the entire gift tax exemption amount of \$2M, and apply GST exemption to the gift.
3. And/or the LLC entity is created so as to fund an ongoing gift program using the Family’s present interest exclusion gifts. Say for 5 years, using all the present interest exclusion amounts for all children and grandchildren.
4. Dad contributes 100% of all property to LLC, and takes back all property interests on Day One.
5. The Operating Agreement from Day One lodges all management power in the “Management Committee,” and initially names Dad with four votes, Mom with two votes, and Child #1 with one vote, as the three members of the Management Committee. (If more than one Child is to be involved, the voting power would be restructured accordingly; with two

children, for example, it could be Dad with 6 votes, Mom with 3 votes, and each Child with 1 vote.) It is a self-perpetuating body, and can add additional members to the Management Committee at any time by majority vote, defining the number of relative votes for that new participant on the Management Committee at that time; Dad is therefore in charge of the composition of the Management Committee.

6. The “Operating Agreement” provides that the LLC will be dissolved and its affairs wound up when the decision to do so is made by the majority vote of the Management Committee. Do not require “unanimous” vote of the Management Committee to dissolve, or else Dad does not control that decision by himself, and we want to avoid all exposure to any “gift on formation” attack by the IRS. This structure therefore avoids any possible “gift on formation” attack by the IRS because Dad has contributed all of the assets on Day One and Dad can control the decision to dissolve on Day One. Dad owns 100% of all the economic interests. An LLC can have a single member (in almost all states).

7. Dad thereafter commences to give away his membership interest either all at once or over the next several years pursuant to a gift of the unified credit and/or present interest exclusion gifts and/or the payment of gift tax. The goal in this context is for Dad to give away literally 100% of his membership interest. Mom splits the gifts for federal gift tax purposes. The gift should be made into a Perpetual Trust.

E. See Exhibit 1 for Phase #1.

F. Features of Phase #1:

1. Grantor trust planning for Oxford Perpetual Trust; trust grows income tax free.
2. Mid-term AFR Loan made to trust by Dad; trust grows by growth rate in excess of AFR interest rate.
3. No distributions intended for at least 5 years, so that Perpetual Trust size is maximized.

G. Phase #2: Family Pooling of Capital Entity.

1. Goal here is for Dad and Mom to retain the ownership of limited partnership interest until death of both, for their own economic security.
2. Goal on death is to obtain estate tax valuation discount.
3. In this estate planning context, the question of control by Dad and Mom becomes central. Dad and Mom must each die without the power (Dad by himself alone, or Mom by herself alone) to liquidate the limited partnership entity, or else there will not be a valuation discount attributed to the “lock-in effect.” With no “lock-in effect” the value for estate

tax purposes will include the ability to have access to the underlying assets of the FLP through control of the liquidation power and process.

4. Impact of Section 2704(a). If Dad or Mom have control at the time of their death, but lose that control under the entity's structure as a result of his or her death, you cannot claim a valuation discount for the resulting "lock-in effect" because of the anti-lapse rule of Section 2704(a).

Example: Mom, Dad and Child are the three members of the Management Committee of the LLC, with Dad having four votes, Mom having two votes and Child having one vote, where the Operating Agreement recites that majority vote controls, and further, that the LLC can be dissolved, among other causes, by the majority vote of the Management Committee. Dad owns 50% of the Membership Interest and Mom owns 50% of the Membership Interest. Dad dies, thereby losing his Management Committee position; the voting power does not pass to his estate. Dad's estate cannot claim a valuation discount for the "lock-in effect" as applied to his 50% Membership Interest.

Section 2704(a) provides that if there is a lapse at death of a voting or liquidation right, the lapse is treated as a transfer which is includible in the gross estate of the decedent. The value of that transfer, constituted by the lapse, is the difference between the value of all of Dad's interests in the entity (both his 50% Membership Interest and his position as having majority vote control with the authority to force a liquidation) just before the lapse as if the voting and liquidation powers would never lapse, and the value of Dad's interest immediately after the lapse (only his 50% Membership Interest, with no power to compel liquidation).

In effect, the amount of the estate tax valuation discount constituted by the "lock-in effect" with respect to Dad's 50% Membership Interest, is an additional asset included in Dad's estate for federal estate purposes.

Potential Trap: No Marital Deduction. The IRS could argue that the transfer constituted by the lapse, valued as above, is not an "interest in property" "passing from the decedent" Dad to Mom within the meaning of Section 2056(c), and hence does not qualify for the marital deduction under Section 2056(a), even though Mom is in control of the LLC after Dad passes away.

5. If Dad and Mom each start out on formation of the entity with the power to liquidate, and then later give that power up, the IRS will assert that there was a "gift" under the Section 2704(a) "lapse" rules. A lapse of any voting or liquidation right during lifetime is a taxable gift.

6. Therefore, to avoid possessing control at death, and to avoid giving up control during life (after you first have control), it is clear that Dad and Mom have to start out not in control.

7. Key Planning Questions: In light of the above tax analysis, what structure is best suited to accomplish the goal of Mom and Dad together not having control of the entity at

its inception, yet Mom and Dad having the ability (if absolutely necessary, but beware about exercising it!) to influence control during the operation of the entity, and yet avoid any impact from the Section 2704(a) anti-lapse rule on the death of the first of Mom and Dad, and yet also be able to avoid estate tax valuation problems in the estate of the surviving spouse in terms of avoiding control of the entity by the surviving spouse?

8. Best Structure: Option #1. One excellent structure is a limited partnership with a corporate general partner organized as follows. Assume, for example, an entity with an initial capital size of \$22.8 million dollars (see explanation below). Mom, Dad and Child organize a corporation with \$228,000 of cash contributions, which is 1% of the total capital size with 30% contributed by Dad (or \$68,400), 30% contributed by Mom (or \$68,400), and 40% (or \$91,200) contributed by Child. (If there is more than one Child potentially involved, then each participating Child contributes a proportionate amount of the \$91,200.) The corporation is an S corporation.

The Child's cash contribution should be money originally belonging to that Child which is not traceable to a gift transfer from Mom and Dad, or, less desirably, cash which is traceable to a prior gift from Mom and Dad but where that prior gift can be argued to be "old and cold."

The Child is elected President of the Corporation, and the Child as President represents the Corporation in its activities as General Partner of the FLP.

Note that Mom and Dad together have more than 50% but less than 66-2/3% of the corporate vote. Mom and Dad can therefore together control the Board of Directors of the Corporation, but Mom and Dad together do not have the power to dissolve the Corporation, as that requires a 2/3rds vote. Mom and Dad should not elect themselves to the Board, however, and should not be officers of the corporation.

The Corporation and Mom and Dad individually and the Perpetual Trust then form the FLP, with the Corporation contributing its \$228,000 cash in exchange for a 1% General Partnership interest, and each of Mom and Dad contributing \$9,006,000 of cash or marketable securities, with each taking back a 39.5% limited partnership interest in their individual capacity, and with the Perpetual Trust contributing \$4,560,000 and taking back a 20% Limited Partnership Interest.

See Exhibit 2 for Phase #2.

9. Key Concept: Size of Perpetual Trust is the limiting condition and the "driver" in the achievement of the crucial "Pooling of Family Capital."

Example: \$4,560,000 contributed by Perpetual Trust (this example uses 2008 numbers):

(a) Assume earlier \$2M gift 5 years before; no income tax because of grantor trust planning; grows at 8% per year for 5 years; equals \$2,938,656.

(b) Assume 2 children and 4 grandchildren; 6 times \$24,000 = \$144,000 per year Crummey clause; each gift made at beginning of year, and grows to the end of year 5 at 8% per year = \$912,376

(c) Assume \$3M loan in 6/08 at mid-term AFR of 3.2%; versus annual earnings of 8%; yields 4.8% annual growth realized at the end of each year; which then grows to end of year 5 = \$700,792.

(d) Total size of Perpetual Trust at end of year 5: \$4,551,824.

(e) Rounded up to \$4,560,000.

10. Meaningful “pooling” is judged/guessed/estimated to be 20%; hence, Mom and Dad can contribute about \$18,012,000 in total. Total pooled entity equal to \$22.8M:

-- 1% G.P.: \$228,000

-- 20% L.P. – Perpetual Trust: \$4.56M

-- 79% L.P. – Mom and Dad, or 39.5% each: \$18.012M total

-- N.B.: judgment call as to 20%; if less than 20%; is it really a “pooling”?

11. Continued Ownership. The plan now is for Mom and Dad to continue to own that 39.5% limited partnership interest, and their 30% stock interest in the corporate general partner, until the date of their respective demise. The goal here is to achieve an estate tax valuation discount, while maintaining the asset base constituted by the limited partnership interest as part of the economic security for Mom and Dad until the death of the last survivor.

12. CRUCIAL: Pooling of Family Capital. It is essential in the federal estate tax valuation discount planning arena, for there to be a “pooling of family capital,” and not just the assets of Mom and Dad. This is commented on in several of the recent decided cases. The audit profile and tax risk of an FLP in the estate tax discount context increases very significantly (in the opinion of JJR) if only Mom and Dad are limited partners.

Hence the role of the Lifetime Perpetual Trust. Other participants in the family pool are of course possible. An effort can be made to “entice” children, grandchildren, pre-existing or newly-created family trusts (like newly-formed and funded Section 2642(c) trusts for grandchildren), brothers and sisters, and nieces and nephews to make some contribution in exchange for a proportionate limited partnership interest. Prior (successful!) GRATS can be used to funnel assets to a Remainder trust for children (for example), and that Remainder trust in a subsequent year can become a partner in the “pooling-of-capital” entity. These prior estate planning maneuvers therefore provide synergy for the later federal estate tax valuation discount planning.

13. Death of First Spouse: Avoid Aggregation. This is **CRUCIAL** in the plan. Upon the demise of the first spouse, both the 30% stock interest and the 39.5% limited partnership interest pass into a QTIP Marital Trust for the benefit of the survivor, with the survivor as one of the two Co-Trustees, and the second Co-Trustee being a non-family member who is emotionally sympathetic with the surviving spouse. The surviving spouse in his or her individual capacity has 30% of the stock in the corporate general partner, and the two Co-Trustees of the QTIP Marital Trust have 30% of the stock in the corporate general partner; together, that stock can be voted so as to continue to influence the distribution policy of the FLP.

Pursuant to Estate of Mellinger v. Commissioner, 112 T.C., No. 4 (January 26, 1999), a regular Tax Court opinion authored by Chief Judge Cohen, the interest owned by the QTIP and the interest owned by the surviving spouse individually will not be “aggregated” for purposes of valuation discount planning. See also Nowell v. Commissioner, T.C.M. 1999-15 (filed January 26, 1999), authored as well by Chief Judge Cohen, rejecting aggregation of a partnership interest held by the decedent’s revocable trust (which was taxed in decedent’s estate pursuant to Section 2038), with a partnership interest that was held by QTIP Marital Trusts established by decedent’s predeceased spouse, where the latter were included in the federal gross estate pursuant to Section 2044. Chief Judge Cohen cites his decision in Mellinger for the proposition that aggregation is not appropriate under these circumstances.

14. Section 2704(a) Not A Danger Here. An advantage of this FLP structure as described above is that nothing lapses on the death of the first spouse to die, and therefore Section 2704(a) cannot be relevant.

15. Investment Philosophy of Pooled Family Capital Entity.

(a) Long-term investment horizon: goal is to grow the limited partnership. Child or committee of children are in charge of selection of new investment advisor for pooled family assets. This is another **CRUCIAL** planning step to help demonstrate the bona fide “business” nature of the Family pooling entity. The new investment orientation must be somewhat different than the prior investment orientation followed by Mom and Dad.

(b) See Exhibit 1. When the Perpetual Trust contributes to the Family Capital Pooling entity, Dad and Mom (Ted and Sarah) must resign from Management Committee of Family LLC, after naming children to run the same. Children then choose same new investment advisor to advise at the level of the Family LLC. Not necessary to liquidate the Family LLC in order to implement this plan.

(c) Each family member is offered an opportunity to invest in family pooling of capital for long-term growth. A family member can invest as much as she or he wants, in exchange for proportionate limited partnership interest.

(d) Only planned distribution will be sufficient cash to pay federal/state income taxes; otherwise, General Partner intends to re-invest and grow the investment partnership, for the lifetime of Mom and Dad.

(e) Possible termination of Limited Partnership: will not be terminated until one or two years after Statute of Limitations closes (or closing letter received) on estate administration of survivor or Mom and Dad.

(f) If family member needs to “retrieve” part or all of the investment prior to termination, the General Partner can honor a request for redemption; however, there can be no “right” to redemption.

(g) Mom/Dad Resistance:

- What if Mom/Dad agree that federal estate tax discount is good goal;
- But: Mom/Dad do not want to give up control over the amount contributed to the Pooled Family Capital entity; and
- Do not want to name a child to be in control of the investment policy; and
- Do not want to change investment advisors; and
- Do not want to pursue a (somewhat) different investment orientation.
- Then: tell Mom/Dad this Synergy #2 is not a viable option for them.

16. Best Structure: Option #2

(a) What is discussed above is one excellent structure for federal estate tax valuation discount planning, namely, a limited partnership with a corporate general partner. Another excellent structure is a LLC with a small Class A Membership Interest plus a large Class B Membership Interest, perhaps in the ratio of 10% for Class A and 90% for Class B.

The Class A Membership Interest actually votes to elect individuals to the Management Committee; the Class B Membership Interest is non-voting.

Mom and Dad each subscribe for 30% of the Class A Membership Interest; for example, if 10% was allocated to Class A, then Mom would subscribe for 3% and Dad would subscribe for 3%. The remaining 4% would be subscribed for by children, grandchildren, and other family members, in whatever percentages made sense in terms of those family members who were “eligible” to participate in control.

(b) The disadvantage of the first structure involving a limited partnership with a corporate general partner is that two business entities are created and must therefore be kept track of. The advantage of the Class A/Class B LLC is that only a single business entity is created.

(c) It is crucial if the Class A/Class B LLC structure is used to avoid aggregation on the death of the first spouse with regard to the 30% Class A interest owned by the first spouse to die; see paragraph 13 above, which must be applied strictly in this context to avoid the tax traps discussed.

(d) Section 2704(a) is not a danger in this Class A/Class B LLC context because nothing lapses in terms of a right to vote or a liquidation right when the first spouse passes away.

17. What Was Saved?

1. Ted and Sarah engaged in a large comprehensive plan of valuation discount planning. What transfer tax did they save? (Assume both Ted and Sarah died in year 6.)

2. Gift taxes saved as a result of the assumed 35% valuation discount enjoyed in the funding of the lifetime Perpetual Trust over 5 years and the assumed 8% growth per year; multiplied by 45% tax rate; equals \$1,102,942 in transfer taxes saved.

3. Estate taxes saved on assumed demise of both Ted and Sarah immediately after establishment of Family Pooling of Capital Entity in year 6, as a result of the assumed 35% valuation discount applied against the value of his and her 39.5% Limited Partnership Interest; multiplied by 45% tax rate; equals \$2,836,890 in transfer taxes saved.

4. Total transfer taxes saved as of year 6: \$3,939,832.

5. [It is conceded that there are various other ways of calculating the total transfer taxes saved, using different assumptions, methodologies and timeframes. The “guess” set forth above in paragraph 4 must be regarded merely as approximate.]

IV. SYNERGY #3: USING A GST “ZEROED OUT” CLUT

A. General Context: Problem and Opportunity. Wealthy grandfather has provided substantially for children up to this point. Grandfather now wants to shift his gift-giving attention to grandchildren (age 1 to age 7), and seeks advice as to the best method.

Grandfather also concerned about lack of social conscience on the part of children, and seeks to encourage them to become more socially aware.

Finally, having seen to some extent what has happened to the children, the grandfather wants “productive behavior” standards utilized before distributions are made to grandchildren.

B. Proposed Solution: “Zeroed-Out” Charitable Lead Unitrust, making charitable distributions to Family Private Foundation, with Remainder Interest to Family Perpetual

Trust, where the latter contains “productive behavior” criteria.

C. Techniques Synergized:

1. Charitable Lead Unitrust
2. GST Planning
3. Family Private Foundation
4. Perpetual Irrevocable Trust
5. “Productive behavior” criteria (“incentive planning”)

D. See Exhibit 3: Chart of Planning Structure.

E. Details and Comments:

1. A CLUT enjoys a special “loophole” in the GST tax context, which enables the grandparent to “zero out” the ultimate transfer to grandchildren so that no generation skipping transfer tax is paid; if that remainder interest passes to a Perpetual Trust, then such amount can be held in perpetuity first for grandchildren and then for all subsequent generations, with no exposure to transfer tax liability thereafter. (By contrast, a CLAT must use the more specific rule of Section 2642(e); in effect, no “zero-out” is possible.)
2. See Section 2642(a)(2)(B)(ii)(II). You “prove” to a CLUT remainder interest computed actuarially which is just under your target, which could be (for example) \$1 M as the assumed amount of remaining gift tax applicable exclusion still possessed by Grandfather and Grandmother (in the case where no payment of gift tax is desired), where the remaining GST exemption still available is at least \$1 M.
3. In “proving” to that remainder interest value, the variables in the computation are:
 - (a) the amount of the initial contribution to the CLUT;
 - (b) the length of the charitable term;
 - (c) the annual unitrust percentage payout to charity;
 - (d) the assumed annual total return rate for the CLUT; and
 - (e) the Section 7520 rate in effect for the month in which the CLUT is established.
4. The GST computation drives the technique. The numerator of the “applicable fraction” is the amount of GST exemption allocated by the transferor to the transfer; the denominator is the fair market value of the property transferred on day one into the CLUT, reduced by the gift tax charitable deduction for the present value of the stream of charitable unitrust payments which pass to the Family’s private foundation during the “lead” period of 15 or 20 or 25 or 30 years. See Section 2642(a).
5. Example. Assume Grandfather and Grandmother have previously each used \$500,000 of their gift tax applicable exclusion; there remains a total of \$1M to be used, \$500,000 by each.

S

Assume they have at last \$1M of GST exemption left, being at least \$500,000 for each.

Assume \$3M into a 20 year CLUT.

If the charitable deduction can be manipulated to be \$2M dollars, then the “Applicable Fraction” will be one over one (numerator of \$1M GST allocated, split \$500,000 by each; denominator of \$3M minus \$2M, or \$1M), and the “Inclusion Ratio” will be zero (one minus one).

Therefore, when the remainder interest falls into the Perpetual Trust, it is completely exempt from GST tax exposure forever regardless of the amount of the remainder.

6. No charitable income tax deduction as a result of this structure. Instead, the CLUT itself is an income tax paying trust, which is able to deduct each year 100% of the unitrust payments it makes to the charity that year. A CLUT is not subject to the percentage limitations of Section 170.
7. The Donor himself can serve as Sole Trustee of the CLUT, provided there is no discretionary payment authority.
8. The Donor is not able to serve as a member of the Board or an Officer of the Family Private Foundation; if the Donor did serve and died during the CLUT term (or died within 3 years after resigning as Trustee), then the entire remaining value of the CLUT and the corpus in the Private Foundation would be included in the Donor’s Estate for federal estate tax purposes pursuant to Section 2036(a)(2). No problem re the PF inclusion: 100% charitable deduction. But this would be a disaster with respect to the CLUT inclusion because it does not generate a 100% charitable deduction measured as of the hypothetical date of death of the Donor, since the remainder interest passes to non-charity. See Rifkind v. United States, 5 Court of Claims 362 (1984), and Revenue Ruling 72-552.

F. Numerical Illustrations (the examples are all based on June, 2008): .

1. Common Assumptions. (a) CLUT in June, 2008, when most effective Section 7520 rate is 3.2% (lowest of last three months, which are 3.8% for June; 3.2% for May; and 3.4% for April). (b) 8.0% growth experienced by CLUT, compounded annually, throughout length of term. (c) Charitable unitrust payment made once a year at the end of the year (helps trustees plan for cash flow need). (d) Valuation date is 12 months before payment date.
2. Variable Assumptions. (a) CLUT term (15, 20, 25 or 30 years). (b) Initial corpus (either \$3M or \$5M). (c) What amount of remainder interest one is “proving” to:

either \$1M; or \$2.0M (the amount of applicable exclusion left by one Grandparent acting alone or two grandparents acting together by means of a split gift).

3. Illustration #1:

- \$5M initial corpus
- \$4M charitable deduction (\$3,999,815)
- \$1M remainder interest (\$1,000,185) proved to (covered by applicable exclusion and GST exemption)
- Assumed growth: 8.0% per year
- Assumed term: 20 years
- Necessary CLUT percentage payment: 7.979%
- Private Foundation receives \$7,994,938 over 20 years
- Perpetual Trust funded with \$5,021,042 at end of 20 years, all exempt forever from GST tax
- If the annual growth increases, the necessary CLUT percentage payment does not increase, but the amounts passing to the Private Foundation and the Perpetual Trust increase
- For example, if the annual growth rate is 8.5% (instead of 8.0%) under Illustration #1: the Private Foundation payments increases to \$8,386,444, and the Perpetual Trust funding increases to \$5,547,611.

4. NET Result of Illustration #1: A \$1M GST exempt gift becomes a \$5M Perpetual GST Exempt Fund and the Family's Private Foundation is funded with about \$8M.

5. The charitable income tax deduction structure set forth in paragraph E6 is a crucial feature of the synergy. The CLUT should be funded initially with cash or high basis securities. The annual unlimited income tax deduction will enable the CLUT to pay no income tax in net effect, and therefore be able to "shelter" annual taxable income (a combination of dividends, interest and capital gain) equal to the necessary CLUT percentage payment. In turn, the CLUT will most likely be able to distribute cash or high basis securities to the Perpetual Trust at the end of the term, which is a substantial financial advantage for this structure.

[(By contrast, take \$1M on day one; gift it to the Perpetual Trust; and let it grow over 20 years. It would have to earn 8.39% net of annual income tax to generate \$5,000,000 at the end of the 20-year term, or about 13.98% annually pre-tax for 20 years in a row (assuming combined federal and state tax rates at the trust level equal to 40%), if the same beneficiary feature of having \$5M worth of assets at the 20-year mark with little or no built in capital gain was to be achieved.)]

6. Illustration #2:

- \$5M initial corpus
- \$3M charitable deduction (\$3,000,170)

- \$2M remainder interest proved to (covered by applicable exclusion and GST exemption) (\$1,999,830)
- Assumed growth: 8.0%
- Assumed term: 15 years
- Necessary CRUT percentage payment: 6.117%
- Private Foundation receives \$5,244,710 over 15 years
- Perpetual Trust funded with \$6,614,483 at end of 15 years, all exempt forever from GST tax

7. Illustrations #3, #4, #5 and #6:

- \$3M initial corpus
- \$2M charitable deduction
- \$1M remainder interest proved to (covered by applicable exclusion and GST exemption)
- Assumed growth: 8.0%

#3: 15 year term; necessary CLUT percentage payment equals 7.288%; Private Foundation receives \$3,448,208 over 15 years; Perpetual Trust funded with \$3,336,872 at end of 15th year, all exempt forever.

#4: 20 year term; necessary CLUT percentage payment equals 5.516%; Private Foundation receives \$4,220,329 over 20 years; Perpetual Trust funded with \$4,900,525 at end of 20 years, all exempt forever.

#5: 25 year term; necessary CLUT percentage payment equals 4.438%; Private Foundation receives \$5,228,762 over 25 years; Perpetual Trust funded with \$7,196,676 at end of 25 years, all exempt forever.

#6: 30 year term; necessary CLUT percentage payment equals 3.71%; Private Foundation receives \$6,553,420 over 30 years; Perpetual Trust funded with \$10,577,944 at end of 30 years, all exempt forever.

8. Lesson from Longevity: the longer the CLUT term, the lower is the annual charitable payment percentage necessary to “prove” to the value of the assumed remainder value. The lower the percentage, the greater the gap between the annual appreciation, and the charitable payout, and the greater the funding of the Perpetual Trust.

V. SYNERGY #4: SEMI-PERMANENT JOINT VENTURE FOR BUSINESS SUCCESSION PLANNING

- A. General Context: Problem and Opportunity Child (or children) who are active in business want to take over; Dad willing to retire but needs to receive some further significant payment from the business. Crucial Key Employee (or employees) want some form of equity ownership, and want the family of the Key Employee to be protected in the event of the demise of the Key Employee. Existing business in “C” corporate form

and is very large. Children who are not active in business want to receive ongoing support from family assets.

B. Proposed Solution: Semi-permanent joint venture between new business entity (“Newco”) and existing business (“Oldco”), with Newco owned in part by Oldco, by active child and by Key Employee, and with eventual transition of Oldco’s interest in Newco to Active Child after Dad’s interim economic goals are met.

C. Techniques Synergized:

1. A particular version of “Oldco/Newco” in the form of a semi-permanent joint venture.
2. Conversion of “C” corp to “S” corp.
3. Recap of “S” corp.
4. Valuation discount for gift of “S” corp.
5. A version of Newco in which Dad/Oldco receives distribution of his profit for “X” amount and over “Y” years.
6. “Locking in” the Key Employee with comprehensive protection of his family.
7. Buy-sell agreements within the Newco Operating Agreement.

D. Discussion.

(1) Oldco/Newco is a powerful technique which is also sometimes referred to as Brother-Sister. The most significant recent development in business succession planning is the increasing frequency with which some version of this technique is used. Wide Application: often used in Family situations, or non-Family situations, or where new owners/managers are to be a combination of Family and Non-Family.

(2) Its increasing use is grounded in the recognition that what needs to occur in business succession planning is not that the new ownership/management group needs to purchase the past, but rather that the new ownership/management group needs to share in the future. Let Dad/Mom keep the past; after all, it belongs to them.

(3) No sale of stock, or other transfer of stock, of Oldco occurs; instead, the business conducted by Oldco is transitioned to Newco.

(4) If Active Children are involved in Newco, and there are other children not involved in Newco as the new version of the Family’s operating business, then Dad and Mom can institute systematic gift program for Inactive Children (and grandchildren in those family lines) involving Class B non-voting stock in Oldco (following recap of Oldco).

(5) Components of “Simple” Version of Oldco/Newco Technique

(a) Sale of operating assets, or lease of operating assets, from Oldco to Newco. Beware trap of recapture income in year of sale, even if sale is on installment basis.

(b) Use of name or related name.

(c) Consulting Agreement to Business Owner from Newco.

(d) If relevant, fee for guaranteeing line of credit or bonding. (Ordinary income to Oldco). And/or Oldco loans working capital to Newco on commercially reasonable terms; interest income is taxable to Oldco.

(e) Newco employs the former employees of Oldco.

(f) Old business of Oldco assigned to Newco (if possible), or performed by Newco pursuant to Management Services Agreement.

(g) Newco capitalized initially in minimal manner, but profit (after salaries and tax distribution) must be accumulated until certain target net worth for Newco is achieved.

6. Additional Aspects of “Simple” Version.

(a) If done right, achieves an “estate freeze” for Business Owner’s business. Business Owner will gradually liquefy the entire interest in the business. (The freeze “leaks” to the extent that the Consulting Agreement represents “extra” payment.)

(b) Business Owner’s Company (Oldco) will become a “personal holding company” as a result of this transaction, and this problem area needs to be anticipated and planned for. 2003 Tax Act lowered PHC tax to 15%, however.

(c) Ideal Context: An excellent technique to use (in either the simple form or any more complex version) when Oldco has a great deal of “extraneous” rental and investment real estate, not related to the operating company. Newco buys (or leases) only the operating assets from Oldco.

(d) Also can be used by Business Owner’s Estate after death of Business Owner in a post-mortem re-structuring. (This is often part of the “Red Truck” plan; Dad’s Will or RLT gives this general direction, and leaves all details to be negotiated at that future time between Estate and anticipated owners of Newco.)

(e) See Exhibit 4 for “Simple Version.”

7. Another Option: Dad Retains Control of Newco

(a) Capitalize Newco as S corporation with Class A voting common and Class B non-voting common; or use LLC structure where Dad is in control of Management Committee, with the power both to name one or more successors on Management Committee and to specify their voting power, either during Dad’s lifetime or in his Will.

(b) Used when dominant Business Owner is not ready to choose among several Key Employees and/or family members, as to who will have operational control.

(c) Business Owner bequeaths or sells Class A voting to chosen Key Employee or family member either at time certain in the future (like January 1, 2015, for example), or at Dad’s discretion.

E. Permanent Joint Venture Version of Oldco/Newco.

(1) A variation of the “Oldco-Newco” approach is the “permanent joint venture.” Newco is formed as aforesaid by the group of Key Employees and/or Members of the Family, but then Oldco and Newco form a new Limited Liability Company in which all new business is taken.

(2) The LLC Operating Agreement then defines the working relationship of Oldco and Newco in the new joint venture: capital contributions; equipment contributed or used or rented; organization; officers; profit and loss allocation; management, operations and marketing; use of facilities; insurance issues; cross-indemnification for any bonding; working capital and/or loans for the same; and use of name.

(3) The Operating Agreement permits one of the other Members of Newco (or Newco itself) to purchase the Membership Interest of Oldco at a certain formula price after a certain period of time.

(4) The goal is to develop the LLC business, and after four to ten years, Oldco can be bought out, and Newco can continue with the LLC business.

(5) See Exhibits 5 and 6.

VI. SYNERGY #5: SALE OF GRAT REMAINDER INTEREST

A. General Context: Problem and Opportunity: Senior Generation very enthusiastic about GRATS, especially given the very low Section 7520 rate in recent months. But Senior Generation frustrated by inability to accomplish GST planning with a GRAT. Senior Generation likewise frustrated with mortality risk because the low Section 7520 rate entices the Grantor to want to lock the rate in with a longer term GRAT.

B. Proposed Solution: Longer term GRAT with Grantor selling GRAT remainder interest to previously existing Perpetual/Dynasty trust.

C. Techniques Synergized:

1. Longer term GRAT.
2. Use of the 20% increasing annuity option.
3. Family LLC or Family S corp which passes through cash distributions.
4. Valuation Discount for gift.
5. Perpetual/Dynasty trust.
6. Sale of remainder interest.

D. See Exhibit 7 for Flowchart of transaction.

E. See Exhibit 8 for Planning Memo and Discussion.

I. ETIP rules: no GST planning with a GRAT (Section 2642(f)).

II. Section 2036(a): exception for bona fide sale for adequate and full consideration in money or money's worth.

- Gradow (1990): Federal Circuit and Allen (1961): 10th Circuit (1990)
- D'Ambrosio (1996): 3rd Circuit
- Wheeler (1992): 5th Circuit
- Estate of Magnim (1999): 9th Circuit

III. Section 2702: retention of “qualified annuity interest” cures the abuse which Congress was concerned about; the value of the remainder can be accurately and fairly calculated.

Bottom Line: The Grantor’s estate is not depleted if the Grantor receives consideration equal to the Section 2702 - calculated actuarial value of the remainder interest.

IV. Proposed Transaction:

- No mortality risk: if Grantor dies during term of GRAT, remaining annuity payments are paid to his estate, but otherwise value of GRAT is excluded because of bona fide sale exception.
- No ETIP because no inclusion in estate; no gift element.

F. Additional Practical Aspects to Improve Audit Profile.

1. If possible, Grantor could have established Perpetual/Dynasty trust in a prior year rather than simultaneously with the GRAT creation.
2. Claim a smaller valuation discount on the “passive” LLC Membership Interest (or Class B non-voting stock in the S corp); claim 25% and not 35% or more. Appraiser will no doubt cooperate.
3. Do not “zero out” the GRAT remainder. Manipulate the annuity percentage payment so that the GRAT remainder interest has some significant dollar value on day one, like \$100,000 or more. This is the amount to be paid to the Grantor by the Perpetual Trust/Dynasty trust.
4. Fund the Perpetual trust/Dynasty trust with significantly more than the precise dollar amount needed to pay for the GRAT remainder interest; if the latter is \$100,000, fund the trust with \$200,000 or more, and allocate GST exemption.
5. Most importantly, allocate basis on the sale, and have Grantor report sale on his income tax return, and pay capital gain tax. (Allocation: multiply total basis of assets inside GRAT by fraction, where numerator is value of remainder interest as computed under Section 2702 and denominator is total value of GRAT assets.)

G. Cash Dynamic:

1. Even if the fair market value of the assets in the Family LLC or the S corp never increase at all during the term of the GRAT, still the GRAT remainder will have value to the extent that the cash distributed through the entities to the Grantor exceeds the Section 7520 rate. If that is so, there must be a positive value to the remainder.
2. The dynamic is enhanced by the discounted value of the assets funding the GRAT (the Family LLC Membership Interest or the Class B non-voting S corp stock). The computation base for the calculation of the annuity amount is lower. Whatever cash is available to distribute through the “system” makes a greater impact in terms of satisfaction of the annuity payment amount.
3. Often, if the S corp is successful and makes good profit, the “normal” and “customary” income tax distribution itself becomes the “engine” driving a significant wealth transfer. The S corp declares a tax distribution; the cash goes to the GRAT and out to the Grantor in partial satisfaction of that year’s annuity requirement; and the Grantor pays the same cash to the IRS. If there had been no GRAT, the same amount of cash would be passed through, and all parties would be in the same position, except that the Grantor would still own all of the stock. Instead, to the extent of the income tax distribution cash in excess of the Section 7520 note applied against the discounted asset value, stock was moved to the taker of the remainder.

H. Sample Agreement of Sale: see Exhibit 9.

VII. SYNERGY #6: TRANSFER OF NEW BUSINESS OPPORTUNITY.

A. General Context: Problem and Opportunity.

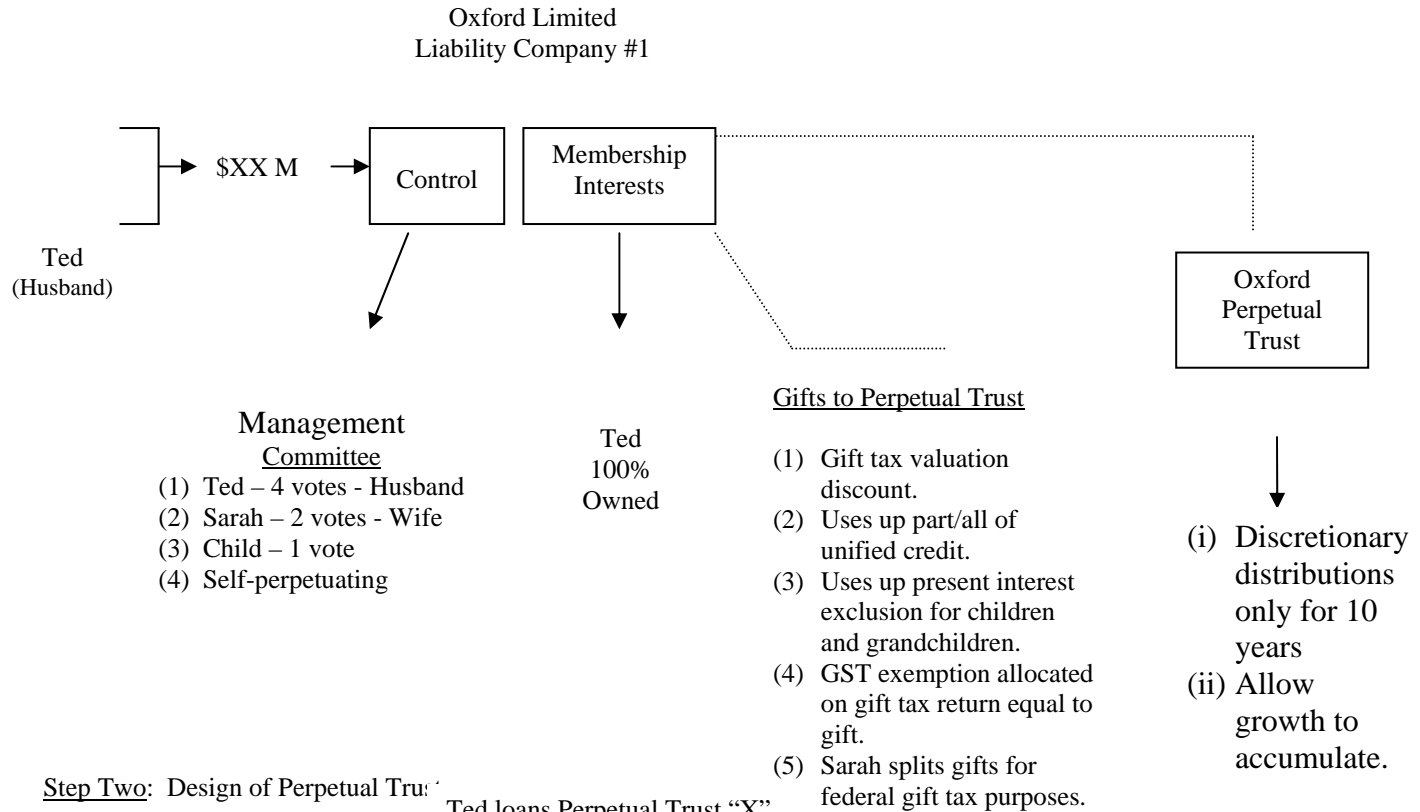
1. Wealthy Business Owner (“Gene”). 2 adult Sons (mid-20’s) working in business now, and making progress. Too soon to tell if either Son is the real successor.
2. Second Marriage. 3rd Son from that marriage is 8 years old. No idea as to business future but Gene wants to preserve possibility of the 3rd son joining the business. New Wife enthusiastic about this idea.
3. New business opportunity. National organization wants Gene as Business Owner to purchase failing business operation in another region (“Oldco”) and “turn it around” for the mutual profit of the Business Owner and the national organization (which will sell product, etc. through the enhanced regional operation). National Organization willing to provide very favorable financing. Owners of Oldco want capital gain.
4. Oldco is S corp.
5. Gene’s estate already worth well north of \$25M. Gene wants to achieve “dramatic” estate tax savings in his estate with regard to possible new success with Oldco.

6. Gene wants to achieve GST savings at the level of any Child who in fact becomes a business successor, on the theory that the business will continue to grow dramatically through the Active Child's generation.
 7. For Child who is not in the business as a successor, allow that Child's share to be distributed during Child's lifetime; no GST planning in that context.
- B. Proposed Solution: Form Newco to acquire Oldco as Q-SUB. Newco controlled by Gene but owned in large part by GST exempt trust. Terms of trust responsive to business succession dynamic.
- C. Techniques Synergized:
1. Opportunity shifting.
 2. Voting/non-voting stock.
 3. Discounted gift to Perpetual Trust.
 4. Grantor Trust Planning. (big impact here!)
 5. Business Succession plan built into Perpetual Trust.
 6. GST Planning.
 7. S corp planning.
- D. See Exhibit 10 for Flowchart of Six Steps.
- E. See Exhibit 11 for Planning Memo.
- F. See Exhibit 12 for Flowchart of Irrevocable Trust.

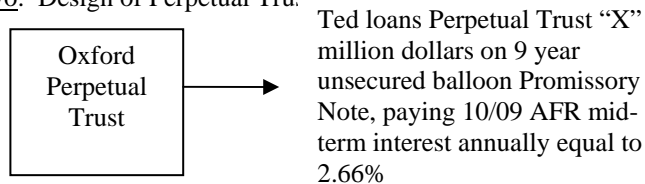
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**SYNERGY #2: Comprehensive Valuation Discount Planning
Phase #1: Lifetime Gift**

Step One: Discounted Gift of LLC Interest to Perpetual Trust



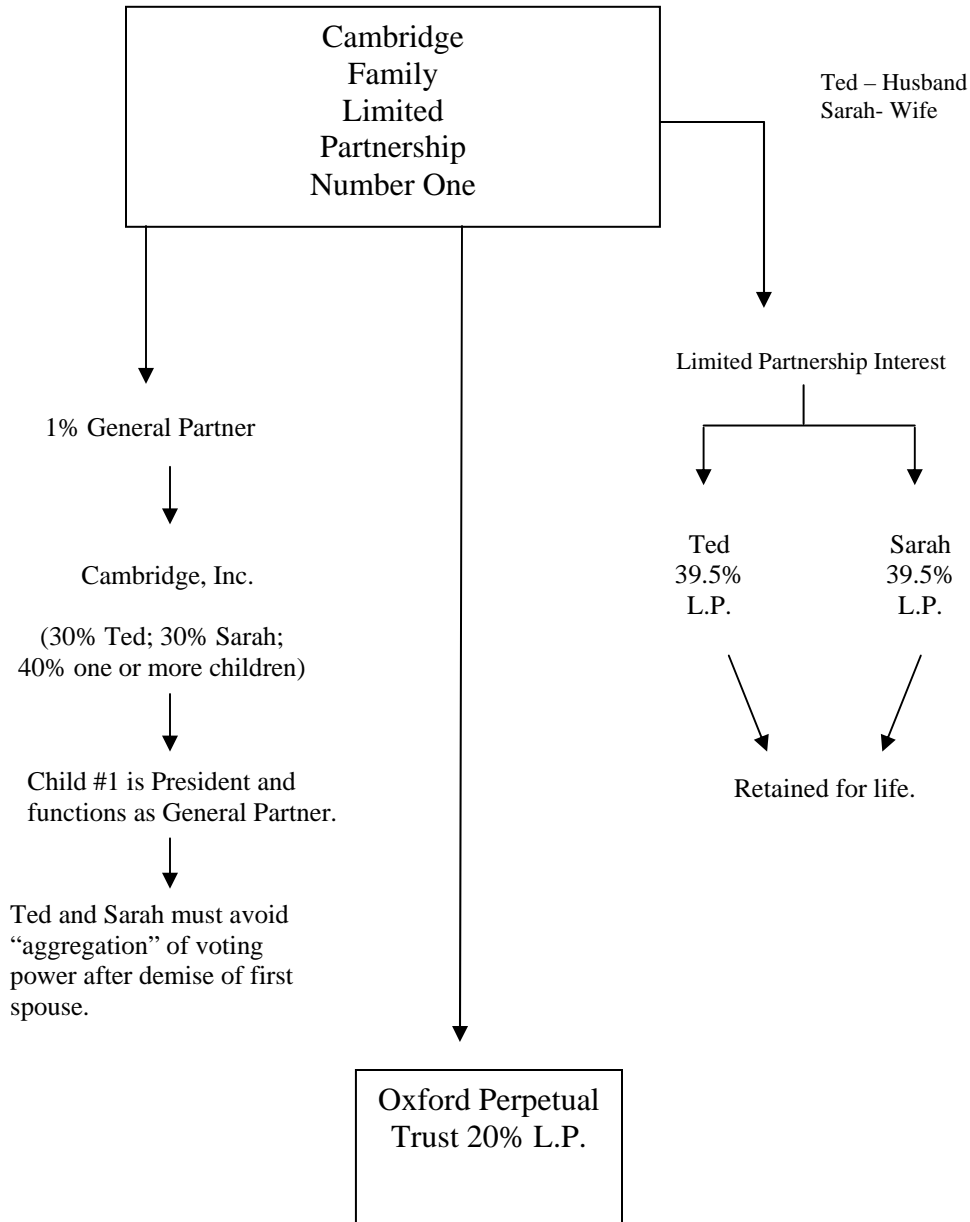
Step Two: Design of Perpetual Trust:



- (1) 3 Shares: Child #1, Child #2, and Child #3 (OR: include spouse Sarah as well).
- (2) Initially, just discretionary distributions; after 10 years, commence 2% unitrust distribution pattern.
- (3) Some % of then FMV (like 5%) distributed to child at age 60, 65, 70, 75 and 80 (a total of 25%) (or other ages).
- (4) Extra principal if needed for support, maintenance and health, considering other financial resources.
- (5) On death of Child, sub-divide for GC in that line (or gift over to other lines if no GC), and repeat pattern at each subsequent generation, except that GC (and each subsequent generation) can take 5% of then FMV at (for example) age 40, 50, 60, 70 and 80.
- (6) No transfer tax ever paid on FMV of principal (provided GST exemption allocated on gift tax return each year).
- (7) Two Trustees at all times:
 - Family Member: Child #1 (OR: Sarah).
 - Non-Family Member: CPA
 - Successor Trustees: named individuals and/or list mechanism; and/or each trustee names successor.
 - As “fail-safe,” Venable(or other professional Firm) fills further vacancy (but not partner or employee)
- (8) Trust Defender
 - Lawyer (or other non-family “technician”).
 - Successor: named individuals and/or list mechanism?
 - Managing Partner of Law Firm (or other professional Firm) fills further vacancy with partner experienced in trust administration and taxation.
- (9) GRANTOR TRUST Planning: Perpetual Trust written so that Ted individually pays all income tax on income received by Perpetual Trust; Perpetual Trust grows larger, faster, outside the transfer tax system. If this option used, then LLC does not file partnership income tax return.

Synergy #2: Comprehensive Valuation Discount Planning

Phase #2: Family Pooling of Capital Entity



ZEROED-OUT CLUT/PRIVATE FOUNDATION/PERPETUAL TRUST

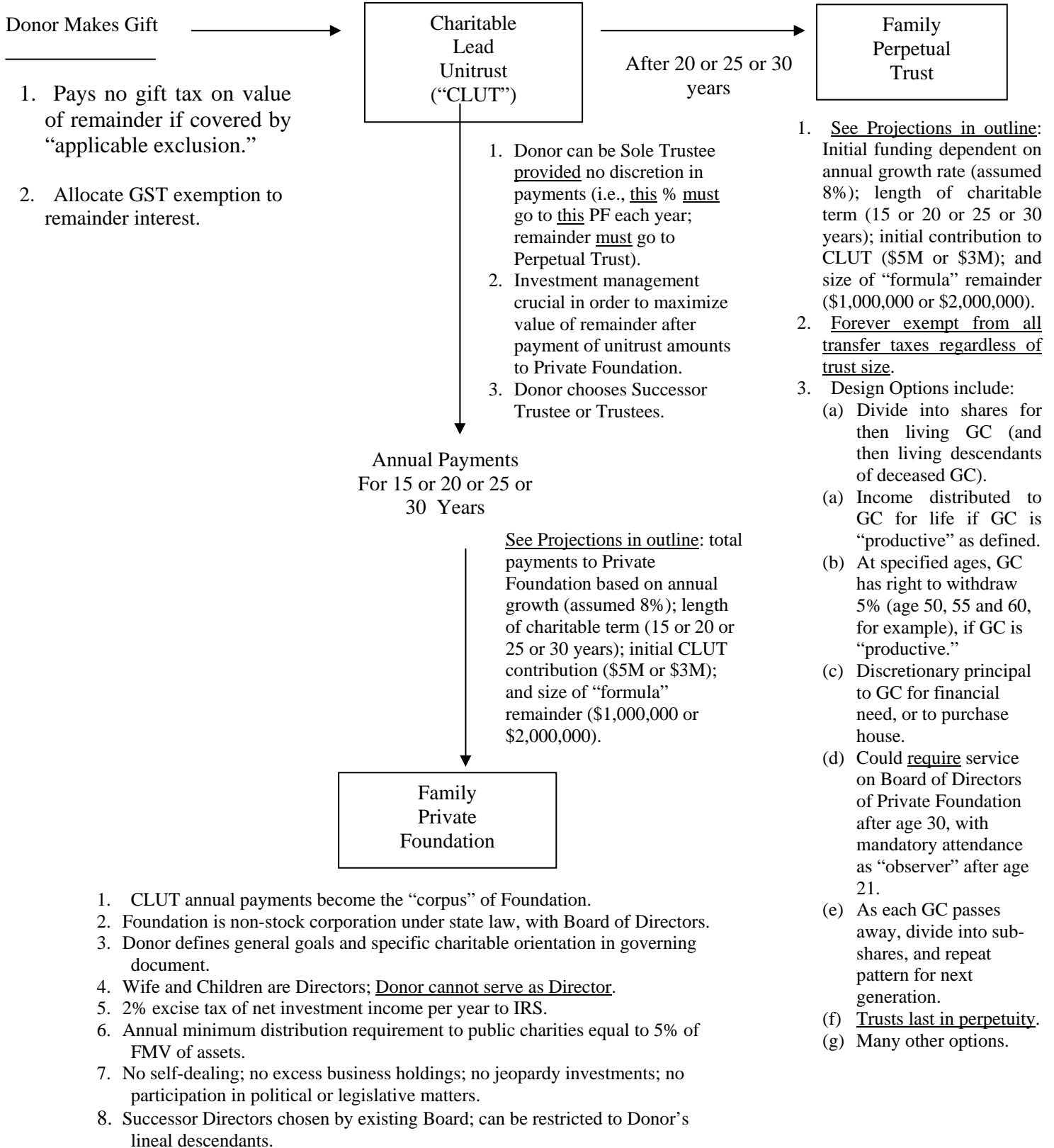
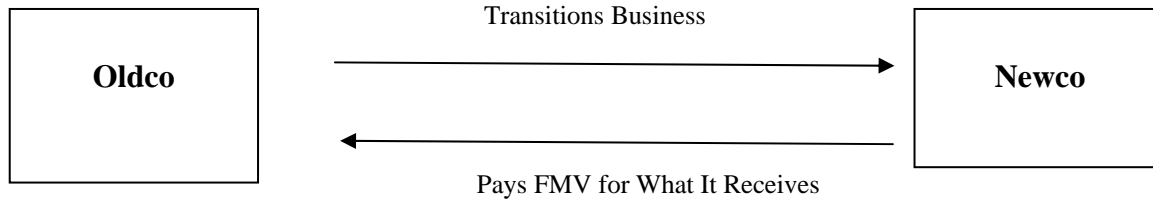


EXHIBIT 4

Exhibit 4 – Transactions Business

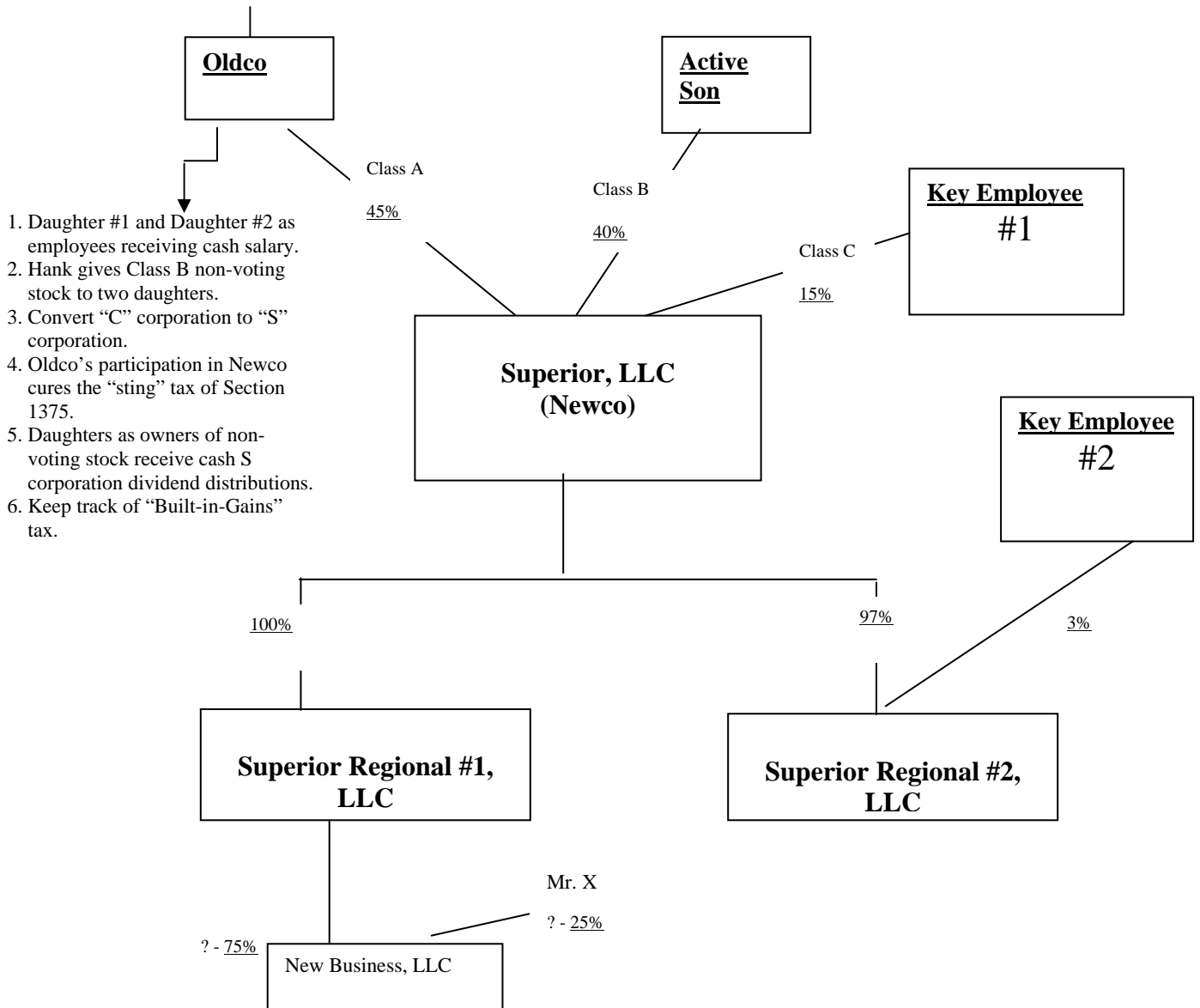


- (1) A “C” Corp. owned by Dad.
- (2) Dad is Consultant to Newco for “X” number of years at “Y” fee.
- (3) Oldco loans working capital, or guarantees line of credit, or guarantees bonding, and receives interest payments and/or guarantee fee.
- (4) Sells/leases equipment to Newco.
- (5) Rents office space to Newco.
- (6) Employees go to work for Newco.

- (1a) A new LLC formed by group of Key Employees
- or
- (1b) A new LLC formed by one or more children
- or
- (1c) A new LLC formed by a combination of Key Employees and children.
- (2) Design governance to respond to goals and needs. Dad should have veto power over certain matters until debt to Oldco is paid off.
- (3) Compensation of Employees of Newco specified by employment contract. A payment of a “bonus” requires the agreement of Dad while any debt or lease obligation is still owed to Oldco.
- (4) Comprehensive Buy-Sell provisions within Operating Agreement, to control buy-back on death, retirement, disability, or termination of employment. Death buy-back funded by life insurance on life of each owner of Newco. (Thus, the family of each owner is protected.).
- (5) Finishes existing projects for Oldco either by contract assignment (if possible) or by Newco executing Management Services Contract with Oldco on “cost plus” basis.
- (6) All new work taken in name of Newco.
- (7) Operating Agreement specifies that only distribution to owners of Newco is to pay federal and state income taxes as defined, until equity in Newco achieves “X” level, and/or debt to Oldco paid off, and/or “Y” number of years elapse. Goal is to build Newco up as viable “stand-alone” business.

New Structure: “Permanent” Joint Venture

Dad Hank – owns 100% of voting stock of Oldco, a “C” Corp. which now converts to “S” status



1. Daughter #1 and Daughter #2 as employees receiving cash salary.
2. Hank gives Class B non-voting stock to two daughters.
3. Convert “C” corporation to “S” corporation.
4. Oldco’s participation in Newco cures the “sting” tax of Section 1375.
5. Daughters as owners of non-voting stock receive cash S corporation dividend distributions.
6. Keep track of “Built-in-Gains” tax.

1. 4 LLCs plus Oldco also useful to isolate liability exposure in a single entity.

See Exhibit 6 for details of Class A, Class B, and Class C.

Class A, Class B, and Class C

Have the following economic attributes (for example):

1. Allocation of Profit and Loss, and distribution of Cash Flow.
 - a) Profit is allocated in proportion to the ownership percentages of 45% for Class A, 40% for Class B, and 15% for Class C, until the aggregate amount of profit allocated to the Class A Interest equals \$10M.
 - b) Profit will continue to be allocated to the respective percentages of the three Classes until the conclusion of the first eight fiscal years of operation of Newco.
 - c) Therefore, after the latest to occur of the \$10M profit target or the 8 year chronological target, additional profit is thereafter allocated 3% to Class A, 82% to Class B, and 15% to Class C. Thus, after Dad (Oldco) is satisfied in terms of its profit and loss preference, the bulk of the profit and loss thereafter shifts to the Active Child. The Key Employee stays constant at 15% of the profit and loss.
 - d) Cash flow is automatically distributed to each of the three Members in the amount measured by the profit allocated to that Member multiplied by the highest combined effective federal, state, and local income tax rate applicable to any of the Members. This is the "income tax distribution" which all Members receive in all years.
 - e) Then the cash flow is automatically distributed to the Class A Member equal to the aggregate amount of profit allocated to the Class A Member (that is, 45% of the whole) for such taxable year (after subtracting the income tax distribution already received for that taxable year by the Class A Member), until the \$10M profit target and the 8 year chronological target are achieved.
 - f) All remaining cash flow is accumulated and added proportionately to the capital accounts of the Class B Member and the Class C Member, until the distribution preferences (both the monetary target and the chronological target) of the Class A Member are fully satisfied.
2. Governance.
 - a) Newco is managed by a Board of Directors. The Class A Member has 3 votes; the Class B Member has 1 vote; and the Class C Member has 1 vote.
 - b) All decisions of the Board require the approval of a majority vote, consisting of at least 3 votes out of 5 votes total. Thus, Dad as President of Oldco and thus owner of Class A controls Newco.

- c) Dad initially is the President of Newco. Active Child is initially the Vice-President. Key Employee is initially the Secretary and the Treasurer. There are employment contracts for each of the three Officers; reasonable compensation is paid for services actually performed for Newco. The employment agreement for the Active Son and the Key Employee contain maximum “non-competition” restrictions.
- d) After the satisfaction in full of the distribution preference provided to the Class A Member (as outlined above), then the Operating Agreement gives the Active Son (if he is still at that time individually the owner of the Class B Membership Interest) the right to purchase the Class A Interest from Oldco (controlled either by Dad if then alive or by Dad’s Estate if Dad has previously passed away), for its then fair market value. “Fair market value” is defined in the Operating Agreement pursuant to a formula which has been determined by an independent appraiser to represent “fair market value”; remember that at this point in time, the Class A Interest is entitled only to a 3% profit allocation (because the \$10M and 8 year preference has been fully satisfied).
- e) It is assumed and anticipated that such purchase will be made. Thereafter, the Active Son will have 4 votes out of 5 votes on the Board of Directors, because the Active Son will own both the Class A and Class B Interests.

3. Buy-Sell Aspects and Transitions.

- a) If the Active Son as owner of the Class B Interest passes away at a time prior to the satisfaction in full of Dad’s Class A distribution preference, then the Son’s Estate has the option to compel Newco to redeem the Class B Member Interest for its then fair market value (or, if larger, the face amount of certain life insurance on the Son’s life purchased by Newco). If the Son’s Estate does not exercise the option to require redemption, then Newco as a Company has a secondary option to compel redemption from the Son’s Estate for the same price and terms.
- b) If the Son’s Interest is redeemed, then from and after the date of closing on the redemption the economic attributes and voting power of the Class B Interest shall pass to and be thereafter enjoyed by the owner of the Class A Interest. Thereafter, Oldco will be entitled to 85% of the profit allocation, etc. This will therefore accelerate the time when Dad’s distribution preference is satisfied in full. After Oldco is satisfied in full, it is still in charge of Newco, however, and thereafter will negotiate an appropriate deal with Key Employee (or with Outsider).
- c) If the Son passes away after the Class A distribution preference has been satisfied, so that the Son has previously purchased from Oldco the Class A Interest, then upon the subsequent demise of the Son, his Estate or Revocable Trust succeeds to his ownership interest, and the Son’s Estate therefore decides what to do with the business (Newco) on a going forward basis. Presumably, the Son’s Estate makes some deal at that point which makes sense with the Key Employee (or with an Outsider). Dad (who has previously been satisfied in full) has no continuing interest

in Newco under the circumstances.

- d) Upon the demise of the Key Employee, his Estate has the right to require Newco to redeem the Class C Interest at the greater of its then fair market value or the face amount of the life insurance which has previously been purchased and maintained by Newco. If the Key Employee passes away prior to the satisfaction in full of the distribution preference for Class A, then after the redemption of the Class C interest, its economic attributes pass to the owner of the Class A interest; if the distribution preference of Class A has already been satisfied at the time when the Class C interest is redeemed, then the economic attributes of Class C pass to the owner of the Class B economic interest. The Family of the Key Employee is protected on his demise, therefore.

There will never be a time when the Key Employee is in control of the business, unless (i) the Class A distribution preference has been satisfied in full, the Son has purchased Oldco's Class A, but the Active Son subsequently dies, and at that time an appropriate deal is then negotiated between the Estate of the deceased Son and the Key Employee who is hypothetically then still alive and active; or (ii) the Son predeceases the Father, the Son's Interest is redeemed, the Class B economic attributes pass to Oldco, Oldco's preference is satisfied in full, and thereafter Oldco negotiates with Key Employee.

- e) If Dad passes away prior to the satisfaction in full of the Class A distribution preference, then his Estate succeeds to his ownership of the controlling interest in Oldco, and thereafter exercises the voting control of having 3 votes out of a total of 5 votes. The distribution preference therefore continues to provide support for the surviving spouse and the other inactive children. Once the distribution preference is satisfied in full, however, the contract right of the Active Son to purchase the Class A Interest thereafter attaches, and the profit percentage of Class A decreases from 45% to 3% as stated above.

BASIC STRUCTURE OF PROPOSED TRANSACTION: Sale of GRAT Remainder Interest

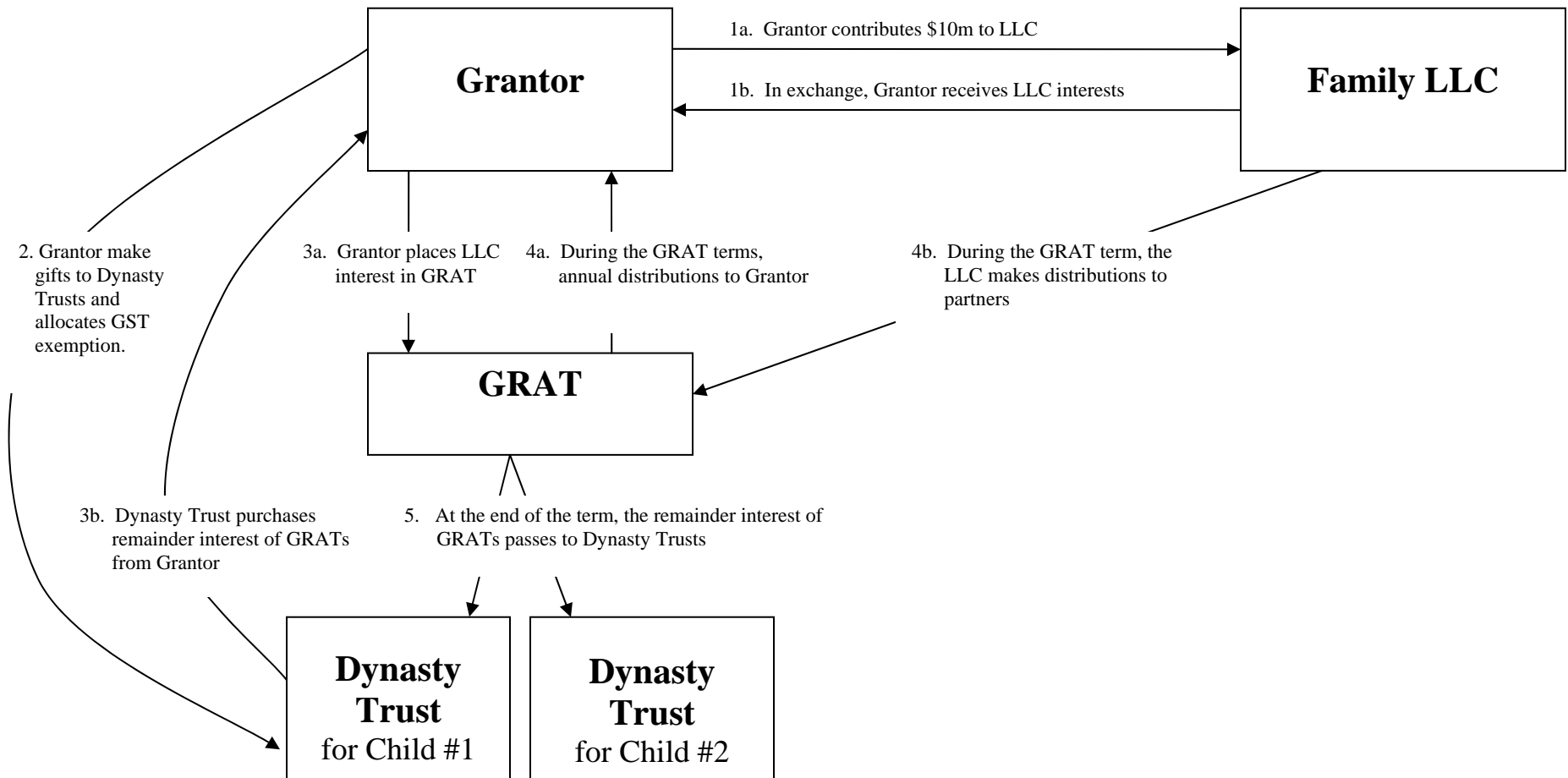


Exhibit 8 – GRAT Planning

MEMORANDUM

TO: FILE

RE: GRAT Planning

PRELIMINARY ADVICE: If the transaction detailed below is desirable to Mr. and Mrs. "X," then a more complete analysis and memorandum will be forthcoming.

FACTS

REDACTED

ISSUE

This memorandum will propose and analyze a transaction in which Husband will transfer the Stock to a grantor retained annuity trust ("Husband's GRAT") and, instead of making a gift of the remainder interest, he will sell the remainder interest to a GST tax-exempt "dynasty" trust for the benefit of Husband's lineal descendants. If the proposed transaction were to withstand scrutiny from the Internal Revenue Service and the courts, upon the expiration of Husband's GRAT, the Stock should forever be exempt from estate tax, provided the Stock remains in a dynasty trust.

DISCUSSION

I. ETIP Rules

The GST tax consequences of a GRAT are not favorable because a grantor cannot allocate any of his GST tax exemption during the estate tax inclusion period ("ETIP"). The ETIP is defined as the period during which, should the grantor die, the value of the transferred property would be includible in the grantor's gross estate or the estate of the grantor's spouse (other than by reason of Section 2035).¹ The ETIP begins on the date the grantor transfers the property and terminates on the first to occur of (i) the death of the grantor, (ii) the time at which no portion of the transferred property would be includible in the grantor's gross estate or the estate of the grantor's spouse (other than by reason of Section 2035), or (iii) a GST tax event.² Any attempt to allocate GST tax exemption during the ETIP will be delayed and will become effective no earlier than the termination of the ETIP.³

Because the Internal Revenue Service (the "Service") takes the position that the value of the entire corpus of a GRAT would be includible in the grantor's gross estate if the grantor does not survive the term of the GRAT,⁴ the transfer of property to a GRAT results in an ETIP. GST tax exemption, therefore, cannot be allocated until the end of the GRAT

¹ §2642(f)(3). All Section references are to the Internal Revenue Code and the regulations promulgated thereunder.

² Treas. Reg. §26.2632-1(c)(3).

³ Treas. Reg. § 26.2632-1(c)(1).

⁴ PLRs 9451056, 9345035 (inclusion under §2039); PLR 9345035 (inclusion under §2036).

term. Because the value of the trust property at the termination of the ETIP, and not its value on the date of the transfer to the GRAT, is used to determine the GST tax exemption inclusion ratio, the delayed effectiveness of the GST tax exemption during the ETIP reduces the ability to leverage the GST tax exemption.

For example, assume grandparent ("GP") transfers \$100,000 of stock to a GRAT with a term of ten years, which provides that GP will receive an income interest for a period of ten years, at which point all trust principal will pass to the benefit of grandchild ("GC"). If GP dies during the ten-year term, the value of the GRAT principal would be included in GP's gross estate under Section 2036(a) and, thus, the GRAT is subject to an ETIP.⁵ Accordingly, any attempt by GP to allocate \$100,000 of GST tax exemption to the GRAT upon the transfer of the stock to the GRAT would be ineffective. Further assume that GP survives the ten year term and the value of GRAT corpus remaining for the benefit of GC is \$500,000. In order to exempt the remaining corpus of the GRAT from GST tax, \$500,000 of GST tax exemption, which corresponds to the appreciated value of the GRAT's corpus at the end of the ETIP, would have to be allocated to the GRAT.

II. Section 2036(a)

One possible way to avoid the unfavorable GST tax consequences associated with a GRAT, as discussed above, would be to structure a GRAT that does not produce an ETIP. In other words, the delay in allocating GST tax exemption may be avoided by structuring a

⁵ Treas. Reg. §26.2632-1(c)(5), Ex. (1).

GRAT such that no portion of the transferred property would be included in the grantor's gross estate even if the grantor died during the term of the GRAT. Such a goal may be accomplished by having the grantor sell (as opposed to gifting) the remainder interest in the GRAT.

As discussed above, the Service takes the position that Section 2036(a) causes the corpus of a GRAT to be included in the grantor's gross estate when the grantor dies during the term of the GRAT. Section 2036(a) provides, in pertinent part:

that 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 case of a bona fide sale for adequate and full consideration in money or money's worth*) (emphasis added) by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death, the possession or enjoyment of, or the right to the income from the property.

Thus, Section 2036(a) effectively discourages manipulative transfers of remainder interests by pulling back the full, fee simple value of the transferred property into the gross estate, except when the transfer was a bona fide sale for adequate and full consideration. The definition of "adequate and full consideration" for the bona fide sale exception of Section 2036(a), however, has been the source of much confusion over the years. The Service, relying primarily upon Gradow v. United States,⁶ takes the position that adequate and full consideration for purposes of Section 2036(a) requires consideration equal to the value of

⁶ 11 Cl. Ct. 808 (1987), *aff'd* 897 F.2d 516 (Fed. Cir. 1990).

the underlying property, while taxpayers have argued that full and adequate consideration need only equal the value of the remainder interest.

Gradow involved a widow's election will, an estate planning technique used in community property states, under which the decedent spouse purports to dispose of the entire community property, with the surviving spouse being left with the choice of either taking under the scheme of the will or waiving any right under the will and taking her community share outright. One common widow's election plan provides for the surviving spouse to, in effect, exchange a remainder interest in his or her community property share for an equitable life estate in the decedent spouse's community property share.

In Gradow, the surviving spouse, Mrs. Gradow, chose to take under her husband's will and, therefore, was required to transfer her share of the community property to a trust whose assets would consist of the community property of both her and her husband, in return for her receipt of all of the trust income for life, and upon her death, the trust corpus being distributed to her son. The executor asserted that the life estate received by Mrs. Gradow was full and adequate consideration under Section 2036(a) for the transfer of her community property share to the trust and, therefore, the executor did not include any of the trust assets within her gross estate. The Service, however, disagreed.

The Gradow court determined that the term "property" in Section 2036(a) referred to the entirety of that part of the trust corpus attributable to Mrs. Gradow. Based upon what it

referred to as "fundamental principles of grammar,"⁷ the court concluded that the bona fide sale exception must refer to adequate and full consideration for the property placed into the trust, and not just the remainder interest in that property.

If the Gradow court had limited its discussion of the Section 2036(a) "adequate and full consideration" exception to the context of a widow's election will, without addressing the sale of a remainder interest, much of the confusion that exists today may have been avoided. In dicta, however, responding to a hypothetical posed by the taxpayer, the Gradow court provided the source for the confusion that exists today by the following passage:⁸

Plaintiff argues that the defendant's construction would gut the utility of the "bona fide sales" exception and uses a hypothetical to illustrate his point. In the example a 40-year-old man contracts to put \$100,000.00 into a trust, reserving the income for life but selling the remainder. Plaintiff points out that based on the seller's life expectancy, he might receive up to \$30,000.00 for the remainder, but certainly no more. He argues that this demonstrates the unfairness of defendant insisting on consideration equal to the \$100,000.00 put into trust before it would exempt the sale from Section 2036(a).

There are a number of defects in plaintiff's hypothetical. Assuming it was not treated as a sham, the practical effect is a transfer of the entire \$100,000.00, not just the remainder. More importantly,

⁷ 11 Cl. Ct. at 813.

⁸ As one commentator observed, "Although the court found [a widow's election will and a sale of a remainder interest] distinguishable, it concluded, in dicta that has become the bane of every estate planner's existence, that the "practical effect" of an outright sale of a remainder interest would be the same – the removal of the underlying fee from the seller's gross estate." Jordan, "The Present State of Sales of Future Interests" *Journal of Taxation*, June, 1998.

however, if plaintiff is correct that one should be able, under the “bona fide sale” exception to remove property from the gross estate by a sale of the remainder interest, the exception would swallow the rule. A young person could sell a remainder interest for a fraction of the property’s worth, enjoy the property for life, and then pass it along without estate or gift tax consequences.⁹

Based upon the Gradow court’s failure to appreciate the time value of money as evidenced by the dicta above, one court stated that “[o]ne can only imagine the enthusiasm with which the IRS received the news that, at least in the view of one court, it would not have to consider the time value of money when determining adequate and full consideration for a remainder interest.¹⁰ The Gradow dicta also led commentators to conclude that Gradow was incorrectly decided because “actuarially-based transactions mystify the courts and the Service.”¹¹ In any event, the Service quickly began to cite the Gradow dicta as controlling,¹² and the government successfully used the dicta to justify inclusion in the gross

⁹ 11 Cl. Ct. at 815.

¹⁰ *Wheeler v. U.S.*, 116 F.3d 749 at 758 (5th Cir. 1997).

¹¹ Horowitz, “*Economic Reality in Estate Planning: The Remainder Interest Sale - Revitalized and Ready for Action*” 75 Taxes No.6, June 1997.

¹² See PLR 9133001 (“For purposes of section 2036(a), in determining whether an adequate and full consideration was received by a decedent upon transferring an interest in property, the consideration received by the decedent is compared to the value of the underlying property rather than the value of the transferred interest; the consideration thus being a replacement of the property otherwise includible in the decedent’s gross estate.”).

estate the value of the full fee interest in the underlying property even where the transferor sold the remainder interest for its undisputed actuarial value.¹³

Despite the government's victory in Gradow, the taxpayers in Estate of D'Ambrosio¹⁴ persuaded the Third Circuit that the Service's interpretation of "adequate and full consideration" under Section 2036(a) was incorrect. In D'Ambrosio, the decedent transferred a remainder interest in her 470 shares of a corporation (with a fair market value of \$2,350,000) to the corporation in exchange for an annuity, and retained her income interest in the shares. Based upon the actuarial tables set forth in the Treasury Regulations, the annuity had a fair market value of \$1,324,014, which equaled the fair market value of the remainder interest.

Upon the death of the decedent, after receiving only \$592,078 in annuity payments, and \$23,500 in dividends, her executrix did not include any interest in the stock when she computed the decedent's gross estate. The Service, however, disagreed and asserted that the gross estate included the full, fee simple value of the stock at the date of death, which was still worth approximately \$2,350,000. The tax court, relying largely on Gradow, determined that the transfer of the remainder interest in the stock was an abusive tax avoidance scheme and ruled that the decedent's transfer of the remainder interest did not fall within the bona fide sale exception of Section 2036(a).

¹³ See *Pittman v. United States*, 878 F.Supp. 833 (E.D.N.C. 1994); *D'Ambrosio v. Commissioner*, 105 T.C. 252 (1995), *rev'd*, 101 F.3d 309 (3rd Cir. 1996).

¹⁴ 101 F.3d 309 (3rd Cir. 1996), *rev'g* and *rem'd* 105 T.C 252 (1995).

In reversing the tax court's decision, the Third Circuit in D'Ambrosio began by stating that while Gradow was a widow election will case and did not actually involve a sale of a remainder interest, the decision was particularly significant because the Gradow court focused on the statutory language of Section 2036(a). The Third Circuit then carefully examined the Gradow court's construction of the statute and concluded that it could not agree with the Gradow court's conclusions that "property" refers to the fee simple interest and that adequate consideration must be measured against that value. Rather, the Third Circuit stated that the clear import of the phrase "to the extent of any interest therein" is that the gross estate shall include the value of the remainder interest, unless it was sold for adequate and fair consideration.

The Service's interpretation of Section 2036(a) was rejected a second time in the Fifth Circuit's decision in Wheeler v. United States.¹⁵ In Wheeler, the decedent sold to his two sons the remainder interest following his retained life estate in a ranch that he used as a personal residence. The price paid by the two sons, \$227,790, was determined by using the actuarial tables and the ranch's appraised value of \$1,314,200. Upon the death of the decedent, the executor did not include any amount for the ranch, thus reflecting the position that the decedent had no interest in the ranch at his death. The Service, however, asserted that the decedent's gross estate should have included the difference between the value of the ranch at the date of death, \$1,074,200, and the consideration paid by the sons for the

¹⁵ 116 F.3d 749 (5th Cir. 1997).

remainder interest, \$338,000. Accordingly, the Service determined that an additional \$736,200 should have been included in the gross estate for the ranch.

Similar to D'Ambrosio, the Fifth Circuit in Wheeler stated that the case ultimately turned on whether the phrase "adequate and full consideration" as used in the parenthetical clause of Section 2036(a) is to be applied in reference to the value of the remainder interest transferred, as the taxpayers contend, or in reference to the value of the full fee simple interest which the transferor had immediately before the transfer, as the government contends. In determining that the taxpayers' interpretation is the correct one, the Fifth Circuit in Wheeler first highlighted the Gradow court's lack of understanding with respect to actuarially-based tax transactions.¹⁶

To illustrate such lack of understanding, the Wheeler court pointed out that if a taxpayer chose to follow Gradow, and somehow was able to find a willing purchaser of his remainder interest for the full fee simple value of the underlying property, the seller would avoid estate tax liability as Section 2036(a) would not be triggered. The buyer, however, will have paid more for the interest than it was worth, having paid the fee simple value for only the remainder interest. Thus, as it is well-settled that for gift tax purposes under Section 2512(b), adequate and full consideration for a remainder interest is its actuarial value, the buyer will have made a gift to the seller in the amount paid in excess of its actuarial value,

¹⁶ See note 11.

thereby presumably incurring a gift tax liability, resulting in what the Wheeler court called carrying “a good joke too far.”¹⁷

In ruling in favor of the taxpayer’s interpretation of Section 2036(a), the Wheeler court also pointed out that significant problems arise when “adequate and full consideration” is given one meaning for gift tax purposes under Section 2512, and another meaning for estate tax purposes under Section 2036(a). The Supreme Court has set forth the general principle that, because the gift and estate taxes complement each other, the phrase “adequate and full consideration” must mean the same thing in both statutes.¹⁸ Thus, because both parties agree that for purposes of the gift tax, adequate and full consideration equals the actuarial value of the remainder interest, the Wheeler court found additional basis for ruling that “adequate and full consideration” under 2036(a) must pertain to the value of the remainder interest transferred, and not to the value of the full fee simple interest.¹⁹

¹⁷ 116 F.3d at 759.

¹⁸ See *Merrill v. Fahs*, 65 S. Ct. 655, 656 (1945) (“The gift tax was supplementary to the estate tax. The two are *in pari materia* and must be construed together.”) See also *Estate of Friedman v. Commissioner*, 40 T.C. 714, 718-19 (1963) (“The phrase “an adequate and full consideration in money or money’s worth,” common to both the estate and gift tax statutes here pertinent, is to be given an identical construction in regard to each of them.”).

¹⁹ Commentators also noted that in *Gradow* and its progeny, “[i]nvariably, the fact that the gift tax and the estate tax actuarial sections are meant to be *in pari materia* was overlooked for one reason or another.” See Horowitz, note 8.

In Estate of Magnin,²⁰ the Ninth Circuit, agreeing with both the Third Circuit's decision in D'Ambrosio and the Fifth Circuit's decision in Wheeler, held that for purposes of Section 2036(a), "adequate and full consideration" need only equal the value of the remainder interest transferred by the decedent, as opposed to the government's view that such consideration must equal the fee simple value of the property. The Magnin court based its decision primarily on its finding that if the government's view was accepted, the bona fide sale exception would be rendered meaningless, as no rational person would ever purchase a remainder interest for the price of the full fee simple interest in the same property. The Magnin court also based its decision upon the "*in pari materia*" argument set forth by Wheeler, noting that the gift tax and estate tax statutes should be construed together.²¹

Thus, there is presently a conflict among the circuits as to whether the phrase "adequate and full consideration" in Section 2036(a) should be compared against the (i) value of a transferred interest, or (ii) full value of the entire property. The Federal Circuit²² and the Tenth Circuit²³ agree that the consideration is not adequate unless it equals the full value of the entire property, while the Third Circuit, Fifth Circuit and the Ninth Circuit take

²⁰ 184 F.3d 1074 (9th Cir. 1999).

²¹ See note 18.

²² *Gradow v. United States*, 11 Cl. Ct. 808 (1987), *aff'd* 897 F.2d 516 (Fed. Cir. 1990).

²³ *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961).

the position that the consideration is adequate if it equals the fair market value of the transferred interest.

III. Section 2702

Based upon the positions held by the Third, Fifth, and Ninth Circuits, a grantor of a GRAT could sell, instead of gifting, the remainder interest to the beneficiaries and take the position that, provided the remainder beneficiaries pay the grantor an amount equal to the value of the taxable gift of the remainder, Section 2036(a) would not pull the value of the GRAT corpus back into his gross estate if he were to die during the term of the GRAT. The cases discussed above, however, were decided on facts prior to the enactment of Section 2702. Thus, the question becomes to what extent, if any, does the enactment of Section 2702 limit the sale of a remainder interest.

Prior to the enactment of Section 2702, the actuarial valuation of remainder interests was often inaccurate because taxpayers could manipulate the investment of the underlying property so as to circumvent the actuarial assumptions, thereby shifting wealth, free of tax, to the remainderman.²⁴ Congress believed that when a parent retained the right to income from a trust, the parent was inclined to direct the trustee to invest the trust assets for appreciation rather than for income and, therefore, the income stream paid to the parent was less than the amount imputed by the actuarial tables. Congress determined that this

²⁴ See Jordan, "Sales of Remainder Interests: Reconciling *Gradow v. United States* and Section 2702" 14 Va. Tax Rev. 671, Spring, 1995.

concern would be addressed by valuing most retained interests at zero, thereby treating the parent as if he or she made a taxable gift of the entire underlying property.²⁵

Under the general rule of Section 2702, whenever a transfer of an interest in trust is made that benefits a family member of the transferor, the transferor's retained interest will be valued at zero for gift tax purposes, thereby resulting in a taxable gift of the entire trust property.²⁶ The general rule will not apply, however, and the value of the retained interest will equal its actuarial value, if the transferor retains a "qualified interest," which includes a right to receive fixed amounts payable not less frequently than annually (a "qualified annuity interest").²⁷ When a transferor retains a qualified annuity interest in the trust, the manipulation with which Congress was concerned can no longer occur, as the transferor's income interest in the trust is completely unrelated to the actual income generated by the trust property.

Some commentators opine that the "sale of a remainder interest" transaction, as sanctioned by the Third, Fifth, and Ninth Circuits under Section 2036(a), remains a viable technique under the enactment Section 2702. For example, one commentator illustrates the benefits of the technique as follows.²⁸ Assume Dad, age 50, created a 10 year GRAT

²⁵ Senate Report, 136 Cong. Rec. S15682 (10/18/90).

²⁶ §2702(a)(1).

²⁷ §§2702(a)(2)(B); (b)(1).

²⁸ Horowitz, "*Economic Reality in Estate Planning: The Remainder Interest Sale - Revitalized and Ready for Action*" 75 Taxes No. 6, June 1997.

funding the trust with \$300,000. Using the February 1997 Section 7520 rate of 7.6%, Dad's retained income interest is valued at \$95,057 and the value of the taxable gift is \$197,508.

If Dad's children were to pay Dad an amount equal to the value of the taxable gift, there would be no taxable gift.

Further assume that Dad dies in year 9 of the 10 year GRAT and the fair market value of the trust corpus is \$400,000. If Dad had gifted the remainder interest to his children, then his estate would include the full \$400,000 of the trust corpus. Because, however, Dad sold the remainder interest to his children (instead of gifting it to them), no part of the trust corpus will be includible in Dad's gross estate under Section 2036(a).

Another commentator states that even under Section 2702, as long as the transferor receives consideration equal to the actuarial value of the remainder interest, the transferor's gross estate is not depleted. She uses the following comparison of a sale of a remainder interest for its gift tax value with a sale of the underlying property for a private annuity to illustrate that the sale of a remainder interest does not deplete the seller's gross estate when applying Section 2702.²⁹ Assume the seller, age 50, owns property with a fair market value of \$100,000 and the applicable rate under Section 7520 is 10%. The seller keeps a qualified annuity interest that will pay \$10,000 a year for life and, thus, the value of the remainder interest will be \$13,182.³⁰ If the seller sells the remainder interest for a private annuity with a

²⁹ See Jordan, "The Present State of Sales of Future Interests," *Journal of Taxation*, June, 1998.

³⁰ Treas. Reg. §20.2031-7(d)(6), Table S.

fair market value of \$13,182, the seller will receive annuity payments of \$1,518.³¹

Accordingly, the seller's combined income from the GRAT and the private annuity is \$11,518 (\$10,000 + \$1,518).

If, on the other hand, the seller sells the entire property for a private annuity, the seller's annuity payments will be \$11,518.³² Thus, regardless of which transaction the seller chooses, her gross estate will include exactly the same amount and, therefore, the sale of the remainder interest puts the seller in the same position as an outright sale and cannot deplete the seller's gross estate.

IV. The Proposed Transaction

The Stock is owned by Husband and included in his taxable estate upon his death. Husband would then transfer the Stock to a newly formed grantor retained annuity trust (the "New GRAT"). Husband will sell the remainder interest in the New GRAT.

The remainder interest will be purchased by a newly-formed trust created for the benefit of Husband's lineal descendants, which will be perpetual, i.e., not subject to the rule against perpetuities (the "Dynasty Trust").³³ When forming the Dynasty Trust, Husband will make a gift of cash to the Dynasty Trust in an amount that will be sufficient to purchase the

³¹ Treas. Reg. §20.2031-7(d)(2)(iv).

³² *Id.*

³³ In 1998, Maryland adopted an exception which allows a trust to be exempt from the rule against perpetuities. §11-102(e), Estates and Trust Article, MD Code.

remainder interest in the New GRAT.³⁴ Husband will make an allocation of his GST tax exemption to the Dynasty Trust in an amount equal to the cash he contributes to the Dynasty Trust. Upon the termination of the New GRAT, the Stock will pass to the Dynasty Trust free of any gift tax or GST tax. Further, because the Dynasty Trust will be fully GST tax exempt, the Stock should forever be exempt from estate tax so long as the Stock is held by the Dynasty Trust.

The creation of the New GRAT should not produce an ETIP for the following reason.³⁵ Relying upon the holdings of the Third, Fifth, and Ninth Circuits with respect to the sale of a remainder interest, if Husband sells the remainder interest in the New GRAT for adequate and full consideration based on the actuarial value of the remainder interest, the bona fide sale exception of Section 2036(a) should apply. Accordingly, if Husband were to die during the term of the New GRAT, the corpus of the New GRAT should be excluded from his gross estate because he sold, rather than gifted, the remainder interest.³⁶

³⁴ As the sale of the remainder interest will be a taxable event, Husband will incur an income tax liability based upon gain he recognizes from the sale. In order to reduce Husband's income tax liability upon a sale of the remainder interest, however, the New GRAT should be nearly "zeroed-out," meaning that Husband's qualified annuity interest should be set at an amount such that the value of the remainder interest is very low. See McCaffrey, Plaine and Schneider, "The Aftermath of Walton: The Rehabilitation of the Fixed Term, Zeroed-Out GRAT," *Journal of Taxation*, December, 2001.

The value of the remainder interest that will be purchased by the Dynasty Trust must, however, have some value so that the sale of the remainder interest will be respected. In other words, if the New GRAT were completely zeroed-out, there would be nothing for Husband to sell. In any event, so long as the Dynasty Trust pays full and adequate consideration for the remainder interest (following *D'Ambrosio, Wheeler and Magnin*), the sale should presumably be respected, regardless of its value.

³⁵ [Footnote omitted]

³⁶ See the example accompanying note 28.

Further, the ETIP is defined to terminate upon the time at which no portion of the transferred property would be includible in the grantor's gross estate or the estate of the grantor's spouse. Thus, because the bona fide sale exception of Section 2036(a) should prevent the property of the New GRAT from being included in Husband's estate at his death, the creation of the New GRAT should not produce an ETIP. In other words, technically, the ETIP would begin when Husband transfers the Stock to the New GRAT, but would simultaneously terminate when Husband sells the remainder interest (because the sale of the remainder interest would prevent estate tax inclusion under Section 2036(a)).

As an alternative approach, some commentators have suggested that instead of having the grantor sell the remainder interest, the grantor would enter into a typical GRAT and make a taxable gift of the remainder interest to the remaindermen.³⁷ The remaindermen would then sell the remainder interest to a dynasty trust which would be funded by the grantor of the GRAT. Once again, the grantor would contribute cash to the dynasty trust in an amount sufficient to purchase the remainder interest from remaindermen. In addition, the grantor would allocate his GST tax exemption to the dynasty trust in an amount equal to the amount of cash he contributed to the dynasty trust. Similar to the proposed transaction, upon the termination of the GRAT, the GRAT corpus would pass to the dynasty trust free of any gift tax or GST tax. Unlike the proposed transaction, however, the commentators' suggested approach does not eliminate the mortality risk of the GRAT.

³⁷ See Oshins and Sederbaum, "Generation-Skipping and The GRAT: Sale or Gift of the Remainder," Estate Planning, June, 2003.

That is, because grantor made a taxable gift of the remainder interest (as opposed to selling the remainder interest), the entire corpus of the GRAT would be included in his gross estate if he did not survive the term of the GRAT.

* * *

U.S. Treasury Circular 230 Notice: Any tax advice contained in this communication (including any enclosures) was not intended or written to be used, and cannot be used, for the purpose of (a) avoiding penalties that may be imposed under the Internal Revenue Code or by any other applicable tax authority; or (b) promoting, marketing or recommending to another party any tax-related matter addressed herein. We provide this disclosure on written communication to assure compliance with new standards of professional practice, pursuant to which certain tax advice must satisfy requirements as to form and substance.

* * *

AGREEMENT OF SALE

THIS AGREEMENT is made effective as of the ___ day of _____, 2008, by and between _____ ("Seller") and the DYNASTY TRUST DATED _____, _____, _____, Trustee ("Buyer").

In consideration of the mutual covenants and agreements made herein and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties to this agreement, intending to be legally bound, agree as follows:

1. **Purpose of Agreement.** Seller currently owns _____ Shares of _____ S Corp (the "Stock"). Seller wishes to convert his interest in the Stock to a steady, fixed income stream for a term of years regardless of whether the Stock increases or decreases in value through the creation of a Grantor Retained Annuity Trust (the "GRAT"). The "Remainder Interest" is the remaining value of the GRAT pursuant to ITEM THIRD of the IRREVOCABLE GRAT AGREEMENT OF Seller. Buyer wishes to acquire the Remainder Interest of the GRAT at the end of the term and is willing to pay the Seller for the present value of the Remainder Interest in the GRAT without regard to whether the Stock is worth less at the end of the term of the GRAT. The purpose of this Agreement is to set forth the terms of the purchase and sale of the Remainder Interest in the GRAT.

2. **Sale of Remainder Interest.** Seller hereby agrees to sell to Buyer and Buyer hereby agrees to purchase from Seller the Remainder Interest in the GRAT simultaneously with the execution and delivery of this Agreement for the consideration set forth herein and otherwise upon the terms set forth herein.

3. **Purchase Price.** Buyer agrees to pay for the Remainder Interest in the GRAT a purchase price (the "Purchase Price") equal to One Hundred Forty-One Thousand Seven Hundred Seventy-One Dollars and Forty Cents (\$141,771.40), in one payment to be made simultaneously with execution of this agreement.

4. [Omitted]

5. **Closing.** The sale described herein shall be effective simultaneously with execution and delivery of this Agreement. At the time of execution and delivery of this Agreement, the parties shall simultaneously deliver the following documents and items:

a. Documents to be delivered by Seller to Buyer:

(i) An executed Grantor Retained Annuity Trust naming the Buyer as a beneficiary of the Remainder Interest.

b. Items to be Delivered by Buyer to Seller:

(i) The payment of the Purchase Price in the amount of One Hundred Forty-One Thousand Seven Hundred Seventy-One Dollars and Forty Cents (\$141,771.40).

c. Location. Execution and delivery of this Agreement and closing hereunder shall be held at the office of Venable, LLP, at 1800 Mercantile Bank and Trust Building, Two Hopkins Plaza, Baltimore, Maryland 21201 or at such other location to which the parties may agree in writing.

6. **Costs of Sale.** The Seller will pay the legal fees of Venable, LLP incurred in connection with the drafting and negotiation of this Agreement and the other documents required to be delivered at Closing. Otherwise, each party shall be responsible for retaining and paying such counsel as it may determine is required and for any other expenses that it may incur.

7. **Representations and Warranties.** Seller hereby represents and warrants to Buyer, as of the date of this Agreement, that

a. Title to Remainder Interest. Seller owns and will convey to Buyer the Remainder Interest in the GRAT free and clear of any pledges, liens, encumbrances or other rights or claims of third parties or other restrictions. Seller has the full legal power and all authorization required by law to sell, transfer, and deliver the Remainder Interest in the GRAT to Buyer and, upon the sale of the Remainder Interest in the GRAT to Buyer and delivery of the documents required to be delivered at Closing, Buyer will own the Remainder Interest in the GRAT free and clear of any liens, encumbrances, claims or other rights of third parties or restrictions except for the obligation to pay the Purchase Price and such other rights or claims granted by Buyer.

b. Due Execution and Valid and Binding Obligation. This Agreement has been duly and validly executed by Seller and constitutes his valid and binding obligation, enforceable against him in accordance with its terms.

c. Representations Complete and Correct. To the best of Seller's knowledge, no representation or warranty by Seller in this Agreement or in any document delivered

pursuant to this Agreement contains any untrue statement of a material fact or omits or fails to state a material fact necessary to make the statements contained herein or therein not misleading.

7. Acknowledgements by Buyer and Seller.

a. Seller acknowledges that he has been advised by legal counsel and understands that the Purchase Price is One Hundred Forty-One Thousand Seven Hundred Seventy-One Dollars and Forty Cents (\$141,771.40).

b. Buyer acknowledges receipt of the documents required to be provided pursuant to this Agreement. Buyer acknowledges that it understands that it is obligated to pay the purchase price of One Hundred Forty-One Thousand Seven Hundred Seventy-One Dollars and Forty Cents (\$141,771.40).

8. Indemnification.

a. The covenants, representations and warranties of Seller contained in this Agreement shall survive closing.

b. The Seller hereby agrees to indemnify Buyer against any loss, cost, damage, or expense reasonably incurred as a result of failure to convey to Buyer good title to the Remainder Interest in the GRAT or a breach of any of the representations or warranties of Seller contained herein, provided that Seller shall not be liable under this indemnity for any breach of any representation or warranty, if, prior to closing, Buyer was aware of the facts or circumstances constituting such breach.

c. If any claim or demand for which Seller may be liable pursuant to this section, is asserted against and sought to be collected from Buyer by a third party, Buyer shall notify Seller and give Seller the opportunity to assume the defense of any such claim. If Seller fails to resolve such claim or notify Buyer in writing that he will assume the defense of such claim within thirty (30) days after delivery of such notice, Buyer may defend such claim and/or settle such claim and any payment made as a result thereof and any reasonable expense incurred in connection therewith (including attorneys' fees) shall be reimbursable by Seller upon demand. If Seller assumes the defense of such claim, Seller shall be responsible for conducting such defense and for any payment resulting from any unsuccessful defense or settlement of such claim and all expenses incurred in connection therewith. If Seller assumes the defense of any such claim, Buyer may participate with counsel of Buyer's own choosing but the cost of such additional counsel shall be at Buyer's expense.

d. Payment of Indemnity. Seller shall reimburse Buyer for any amount for which it is entitled to indemnification hereunder promptly upon demand. In the alternative, if Buyer has made a demand for payment and provided an itemized account of the amount due, Buyer may offset such amount against any payments of the Purchase Price thereafter becoming due.

e. Limitations on Right of Indemnification. The indemnification herein agreed to be provided is limited to the aggregate amount of the Purchase Price paid hereunder and shall expire with respect to any claims, notice of which has not been given to Seller prior to the earlier of Seller's death or three years after the date of closing.

9. Miscellaneous.

a. Final Agreement. This Agreement is the final and entire Agreement between the parties with respect to the subject matter hereof, superceding any prior agreements, either oral or in writing, made between the parties and may not be amended except by a writing executed by each of the parties to this Agreement.

b. Execution in Counterparts. This Agreement may be executed in one or more counterparts, each of which shall constitute one and the same instrument.

c. Law of Maryland Applies. The parties agree that this Agreement shall be deemed to be made in, interpreted under, and the rights and liabilities of the parties hereto determined in accordance with the laws of the State of Maryland.

d. Successors and Assigns. This Agreement shall be binding upon and inure to the benefit of the parties hereto and their respective heirs, personal representatives, successors and assigns.

e. Notice. Any notice or other communication given or required, pursuant to this Agreement, by either party to the other shall be deemed properly given if in writing and personally delivered or mailed by registered or certified mail, postage prepaid, return receipt requested, or by other delivery service normally providing evidence of delivery to the following:

If to Seller:

[]

If to Buyer:

_____, Trustee
[_____]

or to such other address as either party shall hereafter furnish to the other.

IN WITNESS WHEREOF, the parties hereto have each executed this Agreement this ____ day of _____, 2008, to be effective as of the ____ day of ____, 2008.

WITNESS:

SELLER:

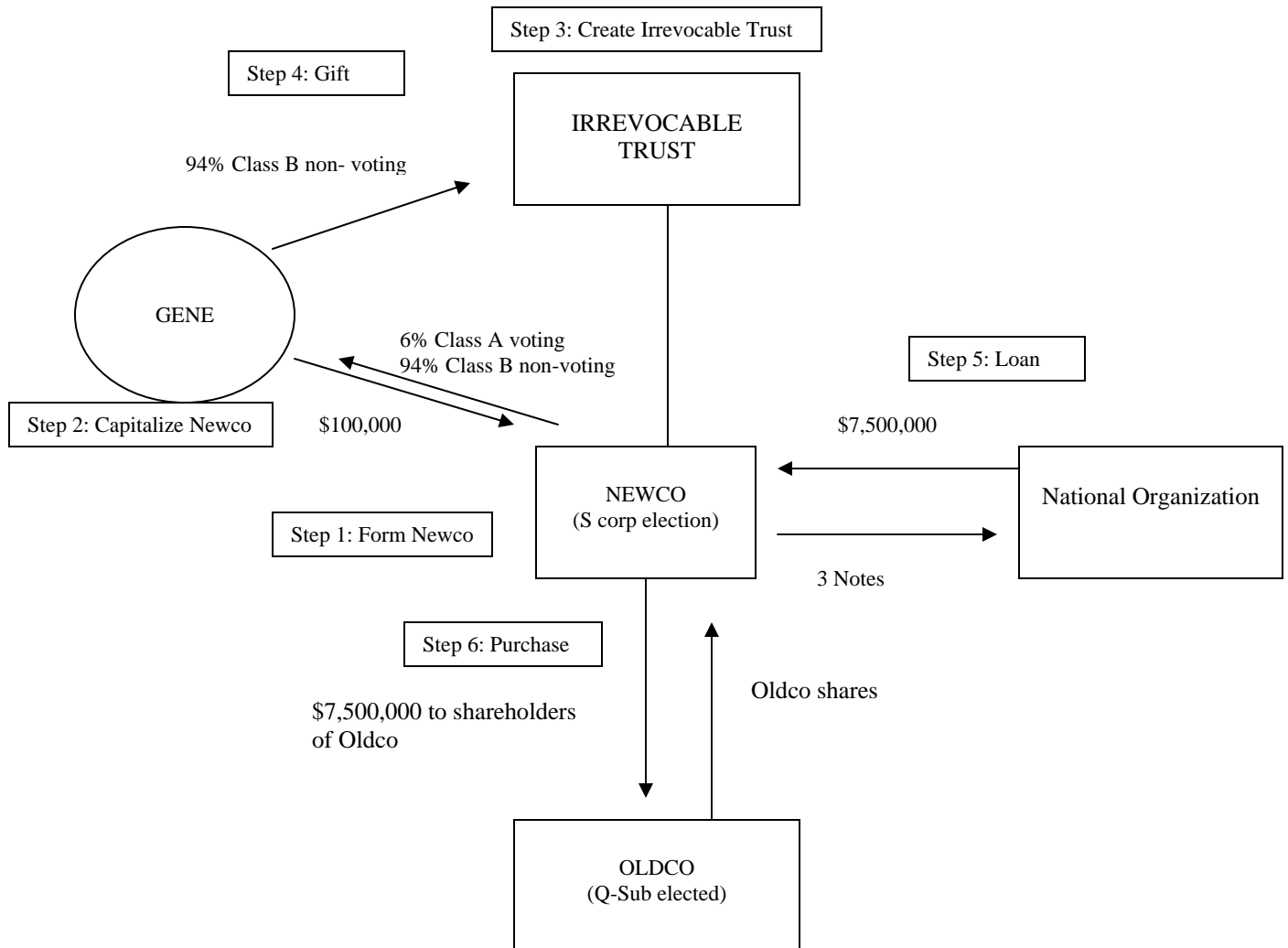
_____ (SEAL)
[_____]

BUYER:

DYNASTY TRUST DATED

_____ (SEAL)
_____, Trustee

EXHIBIT 10



Jeffrey J. Radowich

410-244-7516

jjradowich@venable.com

Memorandum**EXHIBIT 11**

TO:

Gene

CC:

[Members of Team:

- CFO
- Local attorney
- Outside CPA
- Financial Planner]

FROM:

Jeffrey J. Radowich

RE:

Acquisition Structure
Oldco

DATE:

, 2008

Gene:

We will meet at my office to discuss the Oldco acquisition. The purpose of this memo is to summarize our final recommendations regarding the tax planning, the steps that need to be taken in the critical path from now until the March 30 closing, and at least some of the dispositive and fiduciary terms of the trust.

See the chart attached at the end for a quick overview of the six steps.

Summary of the Six Steps

1. **Establishment of Newco.** Newco would be established in Delaware. The reason for using Delaware is outlined below.
2. **Capitalization of Newco.** Gene would capitalize Newco with \$100,000 and would receive, in exchange, a 6% interest in Class A voting stock, and a 94% interest in Class B non-voting stock. This capitalization transaction would not be taxable pursuant to

Section 351 of the Internal Revenue Code. The only difference between the two classes is that Class A votes and Class B does not. There are no economic differences between the 2 classes; for example, if a one dollar per share dividend is declared, the owner of the Class A receives \$6, and the owner of Class B receives \$94. Such voting differences are permitted for S corporations. Newco would make an S corporation election.

3. and 4. **Establish Trust and then Gift to Trust.** Gene would then create the Irrevocable Trust as a Delaware Asset Protection Trust (“DAPT”). See trust discussion below. Gene would then gift his Class B non-voting stock, representing 94% of the Newco equity to the new Irrevocable Trust (the “Trust”). We could assume a 30% discount on the value of the \$94,000 gift, reducing the value of the gift to \$65,800.
5. **Loan.** The Trust would then own 94% of Newco. Newco would have \$100,000 in cash. Newco would borrow an additional \$7.5 million from National Organization, which would be personally guaranteed by Gene. Newco should pay Gene a fee in exchange for his guarantee, in order to guard against a possible gift tax attack; the fee can be modest and can offset in net effect some of Gene’s salary from Newco/Oldco.
6. **Purchase of Oldco.** Newco would then purchase Oldco stock from its shareholders for \$7.5 million in cash. Oldco would be a wholly owned subsidiary of Newco, and would be a QSUB for income tax purposes.

Summary of the Tax Planning For the Irrevocable Trust

7. **Taxable Gifts to Trust.** Transfers to the Trust by Gene are taxable gifts. The taxable gifts can be structured as annual exclusion gifts up to \$24,000 per child if the child is given a temporary right of withdrawal known as a Crummey power.

\$94,000 x 70% (reflecting a 30% discount) is \$65,800. Each of the 3 children can then be given the right to withdraw \$21,934 of the gifted property using a “hanging” Crummey power. No use of Gene’s \$1M lifetime gift giving privilege is required.

8. **Federal Estate Tax Exclusion.** The Trust must be designed to be excluded from Gene’s federal estate tax; this is the primary goal of the planning. Thus, the future growth in value of 94% of the Oldco business and assets would pass in net effect to some combination of Gene’s children free of federal estate tax at the generation level of Gene and [Wife].

Federal estate tax exclusion is therefore an essential goal of the overall tax planning. The complexity in this exclusion context comes from the additional goal of having the Irrevocable Trust be a “grantor trust” for income tax purposes, and, moreover, providing a “solution” for Gene if the income tax burden becomes too onerous. This complexity is discussed below in paragraphs 12 to 15.

9. **Beneficiaries and Trustees.** The primary beneficiaries of the Trust will be Gene's children. The Trustees are proposed to be Mr. X and a Delaware Corporate Trustee.
10. **Electing Small Business Trust.** The Trust can qualify as an Electing Small Business Trust (ESBT). An election to be an ESBT permits the Trust to own shares of an S Corporation. §1361(e). If an ESBT, the Trust itself pays its own income taxes (not Gene as the "grantor," as discussed below). Each potential current beneficiary of an ESBT is treated as a shareholder of the S Corporation. §1361(c)(2)(B)(v).
11. **Grantor Trust.** The Trust can also be a grantor trust for income tax purposes as to Gene. The mechanics of creating a grantor trust are discussed below in paragraph 13. The income of a grantor trust is taxed directly to the grantor. Because the income of Oldco and Newco pass through to the shareholders, which are Gene individually as to 6% and Gene's grantor trust as to 94%, all Oldco and Newco income would be taxed to Gene, if Gene wants to go this route.
12. **Tax Reimbursement.** If Gene had this income tax exposure as to 94%, there could be a feature allowing the Trustee to make a discretionary distribution to Gene, and it is this dynamic that results in our choosing Delaware for the domicile of the Trust.

Here is the reasoning process that leads us to Delaware:

- (a) if the Trust is a grantor trust, then Gene pays the income tax personally on 94% of the Oldco/Newco income;
- (b) this is a good result because the Trust increases outside of Gene's and [Wife's] taxable estate free of income tax, and Gene's estate decreases by his personal payment of the income tax;
- (c) but this result in a given year may be too onerous for Gene, so we need to include in the text of the Trust the ability of the Trustees to (in effect) reimburse Gene for some/all of the income tax burden that year;
- (d) but including that discretionary power for Gene means in almost all states that his creditors can reach the trust property, because the "normal" rule [except in a few "asset protection trust" states like Delaware] is that a creditor can reach the property of a self-settled trust ["self-settled": a trust established by "x" where "x" is himself a beneficiary] to the maximum extent of the exercise of discretion by the Trustee in favor of the Settlor [Gene, in this case];
- (e) and if the creditors can reach the trust property, then the trust property is includable in the federal taxable estate of the Settlor/grantor [Gene] on his demise at then fair market value, because that's the federal estate tax rule;
- (f) so that it is essential to domicile the Trust in a state like Delaware in which (because of specific state law) a creditor of the Settlor/grantor cannot

reach the property of the trust (despite the fact that the Trustees have the ability to make a discretionary distribution to Gene as Settlor/grantor), and hence the trust property is not includable at then fair market value in the federal taxable estate of the Settlor/grantor on his demise.

(g) If the Trust is domiciled in Delaware, it helps to buttress that domicile if the property owned by the Trust also has a Delaware domicile, and hence a Delaware domicile for Newco is recommended. Thus, a Delaware Trust with a Delaware Co-Trustee own Class B non-voting stock of a Delaware corporation.

12A. **“Pre-Arranged Understanding.”** There is a further federal estate tax complexity in this context of a tax reimbursement power for Gene’s benefit.

If the Trust has a Delaware situs, and there is no “pre-arranged understanding” between Gene and the Trustees regarding the exercise of the discretion, then the discretionary payment will not cause inclusion of the Trust in Gene’s estate for federal estate tax purposes. In order to avoid the appearance of any arrangement, the Trustees should be made aware of their complete discretion, and Gene should expect that there will be no pattern of distributions. He will not necessarily receive a distribution simply because he has requested one or because he thinks he needs one.

For example, if in every year in which there is positive grantor trust income tax liability which passes through to Gene, the Trustees decide to make a discretionary distribution to Gene in an amount which corresponds more or less to that liability, and the IRS figures this out at the time of Gene’s demise, the Trust for sure will be taxed in Gene’s estate following his demise. If, on the other hand, such a distribution happens only occasionally, and where the amount is not keyed in an obvious way to the tax liability amount, the Trust will not be subject to taxation in Gene’s estate.

12B. **What is the Amount of Income Tax?** [CFO] and [Outside CPA] should re-examine the “Oldco P&L Forecast 2006-2010” which was part of the acquisition presentation package shared with JJR. It appears to show the following projected federal income tax amounts for 2007 to 2010:

| | | |
|-----------|-------------|---------|
| \$537,000 | - | in 2007 |
| 616,000 | - | in 2008 |
| 818,000 | - | in 2009 |
| 652,994 | - | in 2010 |
| Total = | \$2,623,994 | |

CFO and CPA: What is the combined federal and state income tax liability that John would be responsible for if the trust is a grantor trust? If that burden is too great, consider the option set forth below in paragraph 15.

12C. **Transfer Tax Benefit.** The transfer tax merit is clear: all other things being equal, the trust is \$2,466,554 larger (94% of \$2,623,994) outside of Gene's estate, and Gene's personal estate is \$2,466,554 smaller. If Gene were to pass away in early 2011 (God forbid!), the increase in economic value to the Family from the grantor trust feature by itself (not including the "underlying" value of 94% of the Oldco business) could approximate \$1,726,588 just for those 4 years.

[If grantor trust: then \$2,466,554 is outside Gene's estate for the benefit of the Family, plus the federal estate taxes saved in Gene's estate are about \$863,294, {since his estate is smaller by \$2,466,554, and the taxes at an assumed rate of 35% on that amount are \$863,294}, or total benefit to the family of \$3,329,848.]

[If no grantor trust: then no \$2,466,554 outside the estate for Family's benefit, but Gene's personal estate is higher by \$2,466,554, which after taxes at the assumed rate of 35% leaves \$1,603,260 for the Family's benefit.]

[Difference: \$3,329,848 minus \$1,603,260 equals \$1,726,588 net benefit to the Family from just 4 years of grantor trust treatment.]

Can Gene afford to pay \$2,466,554 in income tax from his personal estate over the next 4 years? If not, see paragraph 15 below.

13. **Grantor Trust Powers.** The fact that the Trustees may make a discretionary distribution to Gene without the consent of an "adverse" party makes the Trust a grantor trust for income tax purposes under Section 677. We can also include [Wife] as a discretionary beneficiary of the trust, along with Gene. This helps buttress the grantor trust status.

There is a tax issue as to which Trustee or Trustees should have the power to make the discretionary distribution to Gene and/or [Wife]. The choices are: (a) Mr. X (or his successor) alone; (b) the Delaware corporate Trustee alone; or (c) the joint decision of the two Co-Trustees. The "safest" choices from the standpoint of the primary goal of federal estate tax exclusion from Gene's estate are (b) and (c). Option (c) is recommended.

See further discussion below in paragraph 18 regarding the terms of the Trust regarding the Trustees.

14. **"Toggle Off" Grantor Trust Status.** [Financial Planner] has suggested in certain communications with JJR that it would be useful to have the ability to turn off the grantor trust status at some point, and then turn on the grantor trust status at another point in the future, etc. This kind of power is usually referred to as a "toggle on and off" power.

JJR is comfortable with the idea of the "toggle off" of the grantor trust status by having the text of the Trust grant to the Co-Trustees the power at any time to renounce the ability to make a discretionary distribution to Gene and/or Wife. If that power is ever renounced

by the Co-Trustees, then the Trust is thereafter not a grantor trust, and becomes instead an ESBT, causing the Trust itself to be responsible for the payment of income taxes attributable to the taxable income.

This power to renounce could be an ultimate “solution” to the situation where Gene found the obligation to pay the income taxes to be onerous. It would not be sufficient for the Co-Trustees to renounce the ability to make a discretionary distribution to Gene, if they still could make a discretionary distribution to Wife; the latter alone would continue to cause the income attributable to the Trust to be taxed to Gene under grantor trust status.

Of course, once Gene passes away, the Trust can no longer be a grantor trust as to Gene; the ability to make a discretionary distribution to Wife after the demise of Gene (if this power had not previously been renounced) would not frustrate the ESBT treatment and would not make Wife herself the grantor of the trust for income tax purposes.

The most important and primary tax planning goal is to have the Trust excluded from the taxable estate of Gene and Wife, as stated above. JJR believes that a one-time exercise of the power to “toggle off” grantor trust status would not frustrate that conclusion. The ultimate factual question in this context is whether the Co-Trustees are administering the Trust independently in accordance with their fiduciary obligation, or whether there is a “hidden agenda” and a disguised pre-arrangement whereby Gene is retaining the unofficial right to manipulate the economic benefits in the Trust. A pattern, for example, of annual distributions more or less in the amount of the income tax liability to Gene would be very strong evidence of a “pre-arrangement,” which would cause federal estate tax inclusion of the then fair market value of the trust property at the time of Gene’s demise.

Ask yourself: why would the Co-Trustees who up to that point had been enjoying income tax free treatment for the benefit of the three children, decide to surrender that income tax benefit, so as to cause the Trust to be a separate income tax paying entity thereafter? The IRS would surely claim that such a decision was because Gene requested relief from the onerous burden of the ongoing income tax liability.

Nevertheless, JJR is prepared to recommend that such a “toggle off” power be included, because it also means that the Co-Trustee can thereafter argue that all distributions in the future must be made only to the three children, and why is it unfair for the Trust itself to be responsible for its own income tax liability?

JJR believes as a judgment call that the situation becomes much more suspicious to the IRS if a further “toggle on” power is included, such that the Co-Trustees could in a subsequent year thereafter invoke a new discretionary power to make distributions to Gene and/of Wife, having previously renounced that discretionary distribution power. An actual exercise of such a “toggle on” power would presumably occur because Gene had sent a signal that it was okay to charge the income tax liability to him again in the future, thereby improving the economics of the beneficiary enjoyment of the three

children. Even the reservation of this kind of “toggle on” power in the text of the Trust, even if it is not ultimately exercised, is in the judgment of JJR further grounds for suspicion by the IRS. It looks like Gene has “retained” the ability to alter the beneficial enjoyment of the trust by means of a “pre-arrangement.”

JJR can find no authority in the case law or rulings that “blesses” both a “toggle off” power and a subsequent “toggle on” power. There really is no explicit authority that “blesses” even a “toggle off” power, but JJR is comfortable with a trust text that permits a one-time exercise of that power by Co-Trustees where at least one of the Trustees is “independent” (the Delaware corporate trustee.)

On balance, therefore, it is not recommended that the subsequent “toggle on” power be included, but JJR is comfortable with a one-time “toggle off” power being present in the text of the Trust.

Financial Planner: We need your further guidance on this issue, as to whether you believe a subsequent “toggle on” power can be included, and in what form that power would be provided. Financial Planner, do you agree that a one-time “toggle off” power, changing the status from grantor trust to ESBT, is an acceptable risk in terms of the federal estate tax exclusion goal for Gene?

15. Critical Path: Steps to be Taken

Step 1: Form Newco

- A. Obtain a resident agent in Delaware.
- B. File Articles of Incorporation in the State of Delaware.
- C. Make an S Corporation election.
- D. Create corporate bylaws and Organizational Meeting minutes..
- E. Open a Delaware bank account in the name of Newco.
- F. Decide whether to hire appraiser for 30% discount worth a total of \$28,200 in value (\$94,000 - \$65,800)

Step 2: Capitalize Newco

- A. Gene contributes \$100,000 to Newco.
- B. Newco issues Class A and Class B stock certificates to John.

Step 3: Create the Irrevocable Trust

- A. Continue working on Trust terms in the interim.
- B. Sign a Trust Agreement and fund with \$10.
- C. Gift to the Trust the Class B Newco stock.
- D. Send out Crummey clause letters.
- E. Make an ESBT election (if necessary).
- F. Sign a buy/sell agreement as between the Trust and Newco.

Step 4: Newco borrows from National Organization

- A. Sign loan documents

B. Newco collects \$7,500,000

Step 5: Newco purchases Oldco stock from shareholders with \$7,500,000.

A. The purchase is closed on _____.

16. Proposed Dispositive Terms of the Trust

- a. Initially, the Trust would be a “one-pot” Trust for the three children, in which the Co-Trustees would be authorized to make distributions in equal or unequal shares to any child (or Custodian in the case of [8 year old]), for that child’s “support in reasonable comfort, or maintenance of the standard of living, or health expenses, or education [broadly defined].” However, no distribution could be made if it would discharge a legal obligation of Gene.
- b. In addition, and assuming that we are to qualify the Trust as a grantor trust for income tax purposes, the Co-Trustees would be authorized to make a distribution of income and/or principal to Gene or Wife. There are no “standards” used to describe this authority, such as “support” or “health”; for tax reasons, the discretion must be absolute and without any standards. Of course, this means theoretically that the Co-Trustees could distribute any sum of money or any property to Gene or Wife, in the sense that the Co-Trustees are authorized by the text of the trust to do so.
- c. The second primary goal of the Trust arrangement is business continuity planning for Gene’s children who are actively involved in the _____ business. Accordingly, the terms of the Trust should contain certain “triggers” which will facilitate ownership of the Class B non-voting common stock by such an active child.

For example, the text could state that if a child attains the age of 35, and has been employed full-time in the family-owned companies for at least 5 years, and if the Co-Trustees believe such a distribution is reasonable and prudent, then the Co-Trustees could either distribute one-third of all of the Class B stock then owned by the Trust outright to that child, or split off that one-third ownership into a separate QSST Trust solely for the benefit of that child, where the child and Mr. X would thereafter be the Co-Trustees (and not the Delaware corporate trustee).

- d. If the option of the split QSST Trust is chosen, then its terms would further provide (for example) that following an additional 5 years of full-time employment, the QSST would terminate by distribution of the stock outright into the individual ownership of the child.
- e. A “QSST” is a “qualified subchapter S trust,” and is permitted to own S corporation shares. It can only have a single beneficiary, and must comply with other administrative rules which in the context of this planning are not difficult.

- f. Of course, as mentioned above, there would already be in existence a “standard” buy-sell agreement, which would prevent the further alienation of the S corporation stock beyond the ownership of the child. The Company would always have an opportunity upon any attempted further alienation to purchase the same at then fair market value (including the application of then prevailing valuation discounts), thereby preventing the stock from ending up in the hands of an inappropriate or unacceptable stockholder; the terms of payment would be favorable for the Company, like being able to pay for the purchase price over as long as 15 years (as selected by the Company), perhaps even with interest only, and a balloon payment at the end, with the minimum “AFR” interest rate as provided by the IRS, etc.
- g. Another type of “trigger” could involve [8 year old] as a child who reaches the age of (say) 30, and who has no intention of becoming involved in the business. The Trustees would be allowed to make that decision even prior to [8 year old’s] attaining age 30. At that point an option would attach, whereby any child who had received a split off QSST or outright distribution because of satisfaction of the prior trigger, would have the right to purchase the Class B stock from the share of the inactive child. Again, the purchase price must be then fair market value, but it could include the application of appropriate valuation discounts for lack of marketability and lack of control, and the payment terms for the active child could be favorable as set forth above. This type of subsequent trigger fulfills the business continuity portion of the plan, so as to end up with Class B non-voting common stock only in the hands of children who are actively involved in the business.
- h. A further decision must be made on the subsequent dispositive terms for an inactive child. At what age or ages does the Trust end by outright distribution into the hands of that child of the investment assets which now form the corpus of that child’s share? For example, 1/3-1/3-1/3 at 40, 45 and 50 (or earlier), could be appropriate, with the ability of the Co-Trustees always to accelerate those distribution dates by outright transfer into the ownership of the inactive child.

18. Proposed Terms Regarding Trustees.

- a. Gene cannot ever serve as Trustee or Co-Trustee. Likewise, it is too dangerous tax-wise to have Wife be eligible to serve as Trustee or Co-Trustee, at least while the power to make a discretionary distribution to Wife exists under the text of the Trust.
- b. It is proposed that a Delaware corporate fiduciary and Mr. X serve initially as Co-Trustees. We must have a Delaware domiciled Co-Trustee in order to be permitted to have a trust domiciled in Delaware. A corporate fiduciary is preferred because it is truly “independent” in the eyes of the IRS with regard to the power to make a discretionary distribution to Gene and/or Wife.

- c. One power that can be safely included is a power to appoint successor trustees to be lodged in Gene, if the Delaware Trustee resigns and/or if Mr. X resigns; Gene cannot safely have the power to remove a Trustee, but can safely have the power to appoint a successor if a then-serving trustee resigns.
- d. The individual Trustee (initially Mr. X) can have the power to remove the Delaware corporate fiduciary. The text should then provide that if the Trust is a grantor trust as to Gene (because Gene is still alive and the “toggle off” power has not been exercised), then Mr. X must appoint a successor Delaware-domiciled Trustee, whether an individual or a corporation.

On the other hand, following the demise of Gene, or following the exercise of the “toggle off” power by the Co-Trustees, the individual Trustee could be given the power to remove the Delaware corporate fiduciary, and then could be given the further power whether to serve alone at that point or appoint a Co-Trustee whether a corporation or an individual, and the domicile of the latter could be any State (rather than only in Delaware). If the trust is no longer a Grantor Trust, then there is no longer a need to perfect the Delaware domicile of the Trust.

- e. Gene can also be given the power in the text of the Trust to name successor individual Trustees to serve, one after the other, following his demise, if a vacancy in the office of individual Trustee develops thereafter. Gene can change this list from time to time during his lifetime.
- f. If Gene’s list ever runs out, then either Wife can be given the power to name successor individual Trustees, or the then-serving individual Trustee can be given the power to name his or her own immediate successor.
- g. If the “toggle off” power has been exercised, so that thereafter no discretionary distribution can be made to Gene, then it is safe thereafter for her to be appointed as Co-Trustee. This might be particularly relevant in terms of the administration of funds for the benefit of [8 year old].

JJR

U.S. Treasury Circular 230 Notice: Any tax advice contained in this communication (including any enclosures) was not intended or written to be used, and cannot be used, for the purpose of (a) avoiding penalties that may be imposed under the Internal Revenue Code or by any other applicable tax authority; or (b) promoting, marketing or recommending to another party any tax-related matter addressed herein. We provide this disclosure on written communication to assure compliance with new standards of professional practice, pursuant to which certain tax advice must satisfy extensive new requirements as to form and substance if it is to be used by the taxpayer as a defense to the attempt to impose penalties by the IRS.

Exhibit 12 – POT Trust

Triggering Event for Active Trust Spinoff:
A child has been employed in the business for at least 5 years and is at least 35. (an "Active Beneficiary"). Item 3A1 and 4, and Item 3B2.



Terms of Active Trust

1. Active Beneficiary receives all income and discretionary principal for SMHE. Item 3C1&2.
2. The Active Trust is intended to be eligible for a QSST election. Item 3E3.
3. On death of Active Beneficiary; he has a limited power of appointment in favor of descendants or a trust for a spouse limited to a 4% unitrust for life. Item 3C3a and 3C3c.
4. If he fails to exercise his power of appointment, then the balance is divided among his descendants, per stirpes, to be held in Active Trusts. Item 3C3b(i) and 3C3c.

Trustees and Other Fiduciaries

1. Individual Trustee: serves most Trustee functions. Item 3A8 and 6A.
 - a. Mr. X
 - b. Gene appoints successor, either directly or through a written list. Item 7B1.
 - c. If further vacancy, an Individual Trustee may appoint his own successor using a list. Item 7B2.
 - d. If further vacancy, then Wife appoints through list. Item 7B3.
 - e. Active Beneficiary is additional co-trustee of Active Trust. Item 7B4.
 - f. Wife is co-trustee of Inactive Trust for 8 year old. Item 7B5.
 - g. Gene cannot be a trustee. Item 7G.
2. Corporate Trustee: serves as administrative trustee. Item 3A8.
 - a. _____
 - b. Gene appoints a successor. Item 7A1.
 - c. Otherwise, the Individual Trustee appoints a successor. Item 7A2.
 - d. Individual Trustee can remove corporate trustee. Successor "Qualified [Delaware] Trustee" must be appointed if necessary for tax planning; otherwise, Individual Trustee may or may not appoint successor corporate trustee. Item 7D and 7A1.

Buyout of Inactive Beneficiary's business interest.
Item 3B3.

1. Individual Trustee of Active Trusts have the right and obligation to purchase business interests from Inactive Beneficiaries and estates. Item 3B3; Item 3B4c; Item 3C3d.
2. The purchase price is fair market value without discounts or premiums. Item 3A7.
3. The price is to be paid by promissory note with the following terms (Item 3B3a, b and c):
 - a. Interest at AFR.
 - b. Amortized over 20 years with a balloon payment at year 15.
 - c. Quarterly payments.
 - d. One-time one-year hardship deferral.

Terms of Pot Trust

1. Beneficiaries receive discretionary payments for support in reasonable comfort, maintenance of their standard of living, health and education (SMHE). Item 3B1.
2. During the lifetime of Gene, the Trustees may pay to Gene or Wife discretionary income or principal. Items 3B5. The trustees may renounce this power. Item 12I.
3. On the death of a child beneficiary, he has a limited power of appointment over his share in favor of his descendants or in trust for the benefit of his spouse (limited to a 4% unitrust interest for life). Item 3B4a.
4. If he does not exercise, his share is divided among his descendants, per stirpes, to be held in Inactive Trusts. Item 3B4b(i). The Active Trusts would purchase the business interests. Item 3B4c.
5. The Pot Trust is intended to qualify as either a grantor trust or an ESBT. Item 3E1 and 2.

Triggering event for Inactive Trust Spinoff:

1. The Individual Trustee determines that a child does not intend to become involved in the business, or if earlier a child reaches age 30 without becoming involved in the business (an "Inactive Beneficiary"). Item 3A2 and 3B3d.
2. A child who is a beneficiary of the Pot Trust dies. Item 3B4c.



Terms of Inactive Trust

1. Inactive Beneficiary receives all income and discretionary principal for SMHE. Item 3D1.
2. When the Inactive Beneficiary reaches age 30, the trust terminates and the balance is distributed outright to the Inactive Beneficiary. Item 3D2.
3. If the Inactive Beneficiary dies before age 30, he has a limited power of appointment over the balance in favor of his descendants or a trust for a spouse limited to a 4% unitrust for life. Item 3D3a.
4. If he fails to exercise his power of appointment, then the balance is divided among his descendants, per stirpes, to be held in Inactive Trusts. Item 3D3b.
5. An Inactive Trust that owns a Family Business interest must sell the same. Item 3D4.

Trustees and Other Fiduciaries (continued)

3. Managing Partner of Venable fills any further trustee vacancy. Item 7C.
4. Special Holdings Director Advisor: acts with respect to closely held entity investments. Item 8A.
 - a. Gene. Item 8E.
 - b. Gene appoints his own successors. Item 8F.
 - c. Otherwise, Managing Partner of Venable appoints successor. Item 8F.
5. Investment Director Adviser: makes investment decisions for other assets. Item 9.
 - a. Gene. Item 9A.
 - b. Gene appoints his own successors. Item 9E.
 - c. Otherwise, Managing Partner of Venable appoints successor. Item 9E.
6. Trust Protector
 - a. "Court of First Resort" to redress fiduciary malfeasance. Item 10A, B and D.
 - b. If necessary, appointed by Venable Managing Partner. Item 10C.
 - c. Issues brief written opinion binding on all parties. Item 10E.
 - d. Does not apply to Gene or Mr. X.