Planning Opportunities: Taking Advantage of Discount Planning with FLPs & IDGTs

By: Thomas L. Walsh, Jr., CFA

With the current structure of Congress post the Georgia run-off elections and tax policy in play to cover the massive budget shortfalls and Coronavirus relief efforts, ultra-high-net-worth ("UHNW") families that have not yet taken advantage of the increased lifetime exemption amounts introduced by the Tax Cuts and Jobs Act ("TCJA") of 2017 may be running out of time to fully utilize the high exemption limits. Recall that the TCJA increased the amount an individual can pass along to their heirs free and clear of federal estate taxes. As of 2021, the indexed exemption amounts are $11.7 million for an individual and $23.4 million for a married couple. Assets above those exemption limits are subject to a 40% federal estate tax rate. In addition, many states will impose their own estate or inheritance tax as well. While there is no current legislation on the table to eliminate or alter this aspect of the TCJA, both our President and Vice President campaigned on a reduction of these exemption amounts and several leaders of the Democratic-controlled House of Representatives and the Senate have been vocal about reductions as well. More recently we have seen a couple of bills introduced which propose aggressive changes to the current gift and estate tax laws.

With this backdrop we think it is highly likely that Congress will put forth a reconciliation bill, or perhaps multiple bills, covering infrastructure and tax law changes. The Senate parliamentarian reportedly approved a process that allows one or more Reconciliation bills this calendar year. Using the reconciliation process, the Democrats can likely pass tax measures using their slim majorities in the House and Senate and forego Republican support. Nevertheless, as we saw with the recent Covid stimulus bill, negotiation may still be required. The reconciliation process is complex and may limit what tax provisions are ultimately included in the final bill.

But this potential timeline has brought the notion of retroactivity of tax changes into question. While not anticipated this year , the further out from January 1 that legislation is introduced, the less likely policy would be made effective as of the first of the year. This may provide those individuals and families who did not act last year a brief window to implement wealth transfer strategies under the current law, however, building flexibility into any plan will paramount given the current uncertainty surrounding tax legislation.

Certain wealth transfer techniques coupled with an estate value "freeze" strategy that use discount valuations and leverage the lower interest rates in order to transfer wealth with little to no gift tax are very attractive. While the strategies below focus on maximizing the tax benefit of wealth transfer planning, it is pertinent that any tax strategy be tempered by your family's primary goals, objectives, and stewardship intent. These illustrations are not meant to be an exhaustive list nor legal guidance.

Family Limited Partnership & Family Limited Liability Company

Whether for an operating company or a collection of investments, wealthy families often create a limited partnerships ("LPs") or a limited liability companies ("LLCs") as a means to organize and manage those assets as well as obtain creditor protection and facilitate transfer tax planning. Depending upon your facts, circumstances, and priorities, your advisors can guide you to the most effective structure for your family.

A Family Limited Partnership ("FLP") is a type of holding company owned by two or more family members where capital is pooled and deployed, perhaps to retain a family business or acquire new assets, real or financial. The partnership consists of two classes of partners: general partners ("GPs") and limited partners ("LPs"). The GPs are responsible for the management of the FLP and its assets. This oversight includes holding regular business meetings, providing financial reports, and timely compliance with all tax and regulatory requirements. In contrast, LPs have no management responsibilities but and have only an economic interest in the partnership.

In the context of intergenerational wealth transfer planning, this arrangement generally allows for control of the partnership to be maintained by the senior generation with the economic benefit accruing to successive generations.

How does this work?

In a typical case, the senior generation will create the FLP and contribute assets to it in exchange for both GP and LP interests. Over time, the senior generation can gift pieces of their LP interests to their children and grandchildren, either outright or in trust.

Due to the lack of control and lack of marketability of LP interests, the courts have recognized that an LP interests can be worth less than the fair value of the assets it owns. This difference creates an opportunity to transfer these LP interests by gift or by sale to future generations at a discount to their fair market value. It is not unusual for these non-controlling, illiquid interests to receive a

discount ranging from 15 to 30%, or possibly more.

To illustrate this concept, consider the exemption limits discussed above of $11.7 million for an individual or $23.4 million for a married couple. Using an FLP to gift a large portion of your estate has the effect of leveraging your exemption amount by taking advantage of the lack of control and lack of marketability discounts. Assuming a 30% discount, you have the ability to transfer $15.21 million as an individual or $30.42 million as a married couple. Further, as the underlying FLP assets continue to grow after gifting, that growth occurs outside of the senior generation's estate.

Other Considerations

It is not uncommon for senior members of a family to express concern around a descendant's ability to manage their own financial affairs. But when that descendant inherits a LP interest, the concern over the descendant's financial management skills is greatly mitigated by laws created to limit creditor rights to any economic benefit the debtor partner has in the family limited partnership and does not give the creditor any control or access to the underlying property within the partnership.

Often, more than one planning technique can be deployed within a given strategy to maximize both the current and future tax benefits while providing great flexibility to future generations. For instance, the FLP interests described above could be transacted through a trust offering additional benefits as described below.

Intentionally Defective Grantor Trust

An Intentionally Defective Grantor Trust ("IDGT") is a type of irrevocable trust where trust property is treated as being owned by the grantor for income tax purposes, but owned by the trust for estate tax purposes. This trust is also known as an Intentionally Defective Irrevocable Trust ("IDIT").

Using an IDGT in the planning process offers substantial benefits as the assets transferred to such a trust, along with all future growth, are treated as being "outside" the grantor's estate for estate tax purposes when the grantor passes. Subject to state jurisdiction limitations, the assets can remain "outside" the estate tax system for generations. In states like Delaware, these "dynasty" trusts can run in perpetuity, for instance. Another tax benefit of the IDGT is that the current income generated by the trust assets is taxable to the grantor. This has a double impact; first, the grantor's taxable estate is further reduced by the tax liability of the IDGT, and second, the assets of the IDGT

grow tax free while the grantor status remains intact.

Gift and sale to IDGT

Let's look at an example that combines the FLP and IDGT planning into a cohesive strategy which addresses the grantor's goals, objectives, and stewardship principles, while maximizing the tax benefits.

Scenario: Tom and Cathy are married with three adult children. Tom is a real estate developer and has built a portfolio of several real estate ventures and partnerships totaling $25 million of value and generating $2 million of income annually. In addition to the real estate investments, Tom and Cathy jointly own their $3 million primary home, their $2 million vacation home in the mountains, and $10 million of liquid stocks and bonds. Their total estate is currently valued at $40 million. With no planning they are looking at an approximate estate tax liability of $6.7 million under the current estate tax laws. If the exemption is allowed to sunset on 12/31/2025, as set forth under the current law, their liability increases to about $11 million. If exemptions are reduced to $7 million for a married couple their liability jumps to over $13 million (assuming the 40% tax rate remains in effect .)

In terms of their family, Tom and Cathy recognize that their three children are very different. One has been successful in real estate and would be a natural candidate to manage the family's real estate portfolio when Tom is no longer able; one is a faithful parent and schoolteacher; and one has bounced from job to job finding it difficult to make ends meet. They love their children (and grandchildren) but have heard tragic stories of squandered wealth. They are concerned about tax law changes but don't want to give up control, and they ultimately desire for their children to benefit equally from the family's wealth.

Solution: Tom and Cathy decide to create a FLP. The FLP is funded with Tom and Cathy's real estate, vacation home and $3 million of stock for a total of $30 million. After some time has passed, they create an IDGT for the benefit of each child (and their respective descendants) and fund these three trusts with partial LP interests in the FLP. Though not fully ready to part with the bulk of their estate, Tom and Cathy determine to use all of Tom's $11.7 million exemption to make a gift to these IDGTs and the remainder of the LP interests by sale. Assuming a 30% discount on the FLP for lack of marketability and lack of control, Tom's gift amounted to $15.21 million and the remaining LP interests owned by Tom and Cathy ($14.79 million) were purchased by the three IDGTs using a 9 year interest only promissory note with a balloon payment at the end of term. These gift and sale transactions account for 100% of the LP interests in the FLP.

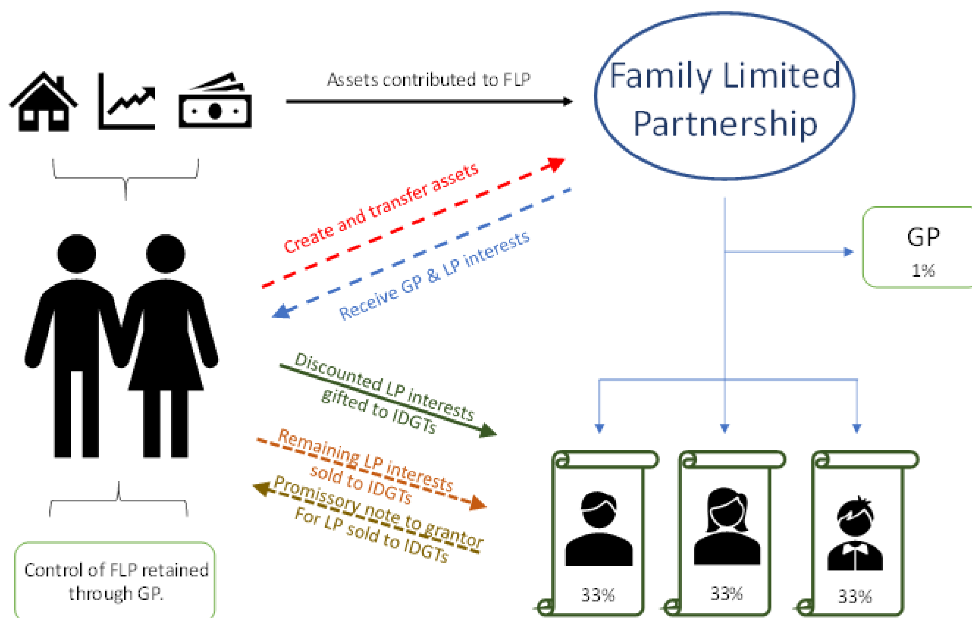
These transactions use all of Tom's remaining exemption and shift these assets along with the appreciation on the FLP out of the estate tax regime for generations. Additionally, Tom and Cathy retain control of the family assets until that is no longer necessary or desired, at which time the FLP facilitates a cohesive succession plan for one child to manage the partnership after Tom and Cathy die, while still approximating equitable use and enjoyment of partnership assets by way of cash flow distributions. Finally, if FLP distributions are made on a pro-rata basis and each beneficiary may not need or desire the full distribution amount, the FLP distributions flow first to each trust. Trust distributions can be at the trustee's discretion. Therefore, FLP distributions are afforded greater oversight and protection by the powers created within the trust.

Not only does this plan offer the potential for substantial estate tax savings, but more importantly addresses Tom and Cathy's broader goals for the family's wealth for generations to come.

Concluding Thoughts

Given the uncertainty with any proposed tax law changes and the timing of the effective dates of such changes, one might reconsider the example above using a Spousal Lifetime Access Trust ("SLAT") as a special form of the IDGT which allows a beneficial interest in trust assets to the spouse in addition to subsequent generations. No matter which beneficiary provisions (SLAT or no SLAT) or type of entity (FLP or LLC), this type of planning cannot wait until year-end.

Family Limited Partnership Example



THOMAS L. WALSH, JR., CFA is a Senior Vice President and Wealth Advisor. Mr. Walsh joins Chilton Trust with nearly 20 years of experience working with ultra-high net worth individuals and families. Thomas has expertise helping clients navigate the wealth transfer and estate planning landscape, next generation and family education, tax planning, as well as ensuring each client's philanthropic legacy has maximum impact.

Prior to joining Chilton Trust, Thomas served as a Principal and Senior Client Advisor at Bessemer Trust where he led a team that advised and implemented strategies for clients in the areas of investment management, estate planning/wealth transfer, tax planning, and philanthropy. He was a senior member of the firm's Officer Committee and Florida Trust Committee. Thomas began his career with an investment focus as a Portfolio Analyst with a Sarasota based RIA and later as a Portfolio Manager with Northern Trust.

Thomas received his MS Finance from the Kelley School of Business at Indiana University and BS Finance from the Lutgurt College of Business at Florida Gulf Coast University, where he graduated Magna Cum Laude. Additionally, he has earned the CFA Charterholder designation and is an honors graduate from the Cannon Trust School. He is a member of the CFA Institute and CFA Society of Naples, where he served as a past board member. Thomas enjoys teaching and mentoring and has served as an adjunct professor of Finance at Florida Gulf Coast University and remains actively involved with the college of business as a mentor and guest speaker. Thomas resides in Naples, Florida with his wife and three children.

www.ChiltonTrustCompany.com

Charlotte	New York	Palm Beach	Stamford	Wilmington
5925 Carnegie Boulevard	300 Park Avenue	396 Royal Palm Way	1290 East Main Street	1105 North Market Street
Charlotte, NC 28209	New York, NY 10022	Palm Beach, FL 33480	Stamford, CT 06902	Wilmington, DE 19801
Phone: (980) 227-3101	Phone: (212) 843-6882	Phone: (561) 598-6330	Phone: (212) 843-6882	Phone: (302) 466-3501

NOTE: This document was prepared by Chilton Trust. Any use of Chilton Trust herein refers to Chilton Trust Company, N.A. and its affiliates, including but not limited to Chilton Investment Services, LLC, and their owners, employees, and agents. Fiduciary services are provided to clients by Chilton Trust Company, N.A.. Investment advisory and portfolio management services are provided to clients, by delegation, by Chilton Investment Services, LLC and other affiliates. This document was prepared by Chilton Trust solely for the benefit and internal use of the client to which it is provided (together with such client's affiliates, the "Client") in order to assist the Client in evaluating, on a preliminary basis, the matters addressed herein. Neither this document nor any of its contents may be disclosed to any other party or used for any other purpose without the prior written consent of Chilton. Not withstanding the foregoing, Chilton Trust and the Client (and each of their employees, representative, or other agents) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of any transaction described herein and all materials of any kind (including opinions and other tax analyses) that have been provided to them relating to such tax treatment and structure. Past performance is not indicative of future results. Any investment in a separately managed account or limited partnership is speculative and involves a high degree of risk. This does not constitute a solicitation to buy or sell securities. The recipient understands that this is prepared for Chilton Trust clients only and that this material includes confidential or proprietary information which may not be shared, in whole or in part, with third parties without Chilton Trust's express written consent.