

# **GRANTOR TRUSTS AND FLPs IN ESTATE PLANNING – GREAT WEALTH MIGRATION PARTNERS**

## **CASE STUDY EXAMPLE ILLUSTRATING TRANSFER PLANNING USING THE FAMILY LIMITED PARTNERSHIP AND THE GRANTOR TRUST**

**by Michael V. Bourland  
Jeffrey N. Myers**

Bourland, Wall & Wenzel,  
A Professional Corporation  
Attorneys and Counselors  
City Center Tower II  
301 Commerce Street, Suite 1500  
Fort Worth, Texas 76102

(817) 877-1088  
(817) 429-3945 (metro)  
(817) 877-1636 (facsimile)  
[mbourland@bwwlaw.com](mailto:mbourland@bwwlaw.com) (Email)

**Presented to**

**FORT WORTH BUSINESS AND ESTATE COUNCIL**

**Fort Worth Club**

**February 20, 2003**

**Fort Worth, Texas**

## **BIOGRAPHICAL INFORMATION**

### **MICHAEL V. BOURLAND**

#### **EDUCATION**

B.A., Baylor University  
J.D., Baylor University  
LL.M. in Taxation, University of Miami, Florida

#### **PROFESSIONAL ACTIVITIES**

Founding Shareholder - Bourland, Wall &Wenzel, P.C.  
Board Certified (Estate Planning and Probate Law) – Texas Board of Legal Specialization  
Fellow, American College of Trust and Estate Counsel  
Former Member, Real Estate, Probate and Trust Law Council (State Bar of Texas Real Estate, Probate and Trust Law Section)

#### **ACADEMIC APPOINTMENT AND HONORS**

Guest Lecturer in Estate Planning at  
Baylor University School of Law  
Baylor University School of Business  
Southern Methodist University School of Law  
The Center for American and International Law  
University of Texas School of Law

### **JEFFREY N. MYERS**

#### **EDUCATION**

B.A., University of Texas  
J.D., California Western School of Law  
LL.M., University of San Diego

#### **PROFESSIONAL ACTIVITIES, ACADEMIC APPOINTMENT AND HONORS**

Shareholder - Bourland, Wall &Wenzel, P.C.  
Board Certified (Estate Planning and Probate Law) – Texas Board of Legal Specialization  
Adjunct Instructor 1998-1999 – University of Texas at Arlington, Continuing Legal Education  
Guest Lecturer in Estate Planning at  
Notre Dame Tax and Estate Planning Institute  
State Bar of Texas – Advanced Estate Planning & Probate  
Texas Society of CPAs – Fort Worth Chapter

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## **FAMILY LIMITED PARTNERSHIP**

Planning tool to own and transfer from one generation to succeeding generations' family businesses, real estate interests and investment assets. It can be custom designed to meet each particular family situation. Top ten (10) reasons for selecting the family limited partnership as a planning tool in ascending order of importance:

- Limitation of Payroll Taxes.
- Accumulation of Wealth.
- Family Training in Management and Growth of Assets.
- State Taxes/Income Tax Flexibility.
- Valuation Discount.
- Consolidation of Assets.
- Asset Protection – Inside and Outside of Family Limited Partnership.
- Separate Property Maintenance/Pre-Marital Planning.
- Continuity of Management.
- Control, Control, Control.

Increasingly subject to challenge by the Internal Revenue Service based upon the ability to transfer assets owned by the family limited partnership to succeeding generations at a discounted value. Of particular concern are family limited partnerships utilized to transfer investment assets to the next generation at a discounted value. Areas of possible attack by the Internal Revenue Service include the following:

- Lack of Bona Fide Business Purpose/ Withdrawal Rights.
- “Applicable Restriction” under Section 2704 of the Internal Revenue Code.
- Formalities of Partnership.
- Gift Upon Creation.
- Step Transaction Doctrine.
- Single Testamentary Transaction.

**GRANTOR RETAINED INTEREST TRUST:  
“GRIT”, “GRAT”, “GRUT”, “PRT”, OR “QPRT”**

An irrevocable trust of which:

- The grantor is the owner of the trust for income tax purposes
- The grantor is not the owner of the trust for estate tax purposes unless the grantor dies during the trust term
- The grantor is the owner of the trust for GST tax purposes until the end of the trust term
- Gift to the GRT migrates wealth to the next generation at a leveraged gift tax cost if grantor retains a qualified interest
- If the grantor survives the end of the GRT term and GRT investment goals are met, the value of the gift to children upon the creation of the GRT is significantly less than the value of the assets when the GRT is terminated

**INTENTIONALLY DEFECTIVE GRANTOR TRUST (“IDGT”)**

An irrevocable trust of which:

- The grantor (or in certain cases beneficiary) is the owner of the trust assets for income tax purposes and pays income tax on trust income
- The grantor is not the owner of the trust for gift, estate or GST tax purposes

**INTENTIONALLY DEFECTIVE GRANTOR TRUST (“IDGT”)– GIFT/SALE**

A part sale/part gift transaction of which:

- The grantor creates the IDGT
- The grantor funds the IDGT with an amount at least equal to 10% of amount to be purchased through a deferred payment option – “coverage”
- The grantor (or in certain cases beneficiary) sells assets to the IDGT in exchange for cash or a deferred payment option - promissory note, SCIN or private annuity, deferring income tax until IDGT sells assets
  - Promissory note – flexible terms, interest rate must be at least the appropriate applicable federal rate; unpaid balance of note in estate upon death; certain income tax issues upon death
  - Self-canceling installment note – premium paid for self-canceling feature; no estate inclusion but certain income tax issues upon death
  - Private annuity – no estate inclusion or income tax issues upon death
- Migrates wealth to the next generation at a leveraged transfer tax cost

## CASE STUDY EXAMPLE

The grantor trust (grantor retained interest trust and intentionally defective grantor trust [IDGT]) should be in any sophisticated tax planner's arsenal. However, there is no laundry list which enables the tax planner to check off to determine which of the two techniques is best suited for his or her client. The only way to determine whether the grantor retained interest trust or IDGT is appropriate is to run the numbers.

*A. Phase I – Founder Family*

Goal: Migrate \$10.0 million in large cap growth stocks. Family Data: James Founder, age 66, is married to Sally Founder, age 66. James and Sally have three children: James, Jr., William and Carol. The Founders' estate is approximately \$42.0 million.

*B. Phase II – Planning Options*

Fund Founder Family Investments, L.P., with \$10.0 million in large cap growth stocks under management with Financial Advisors. Founder Management, LLC will own a 1% general partnership interest and serve as general partner, each of Mr. and Mrs. Founder will retain a 4.5% limited partnership interest and each will transfer a 45% limited partnership interest under one of the five options outlined. Under each option it is assumed that the limited partnership interests retained by Mr. and Mrs. Founder will receive a valuation adjustment due to their lack of marketability and lack of control. Considering such valuation adjustment (i.e. 30%) it is assumed that each of 45% limited partnership interest is valued at \$3,150,000 for discussion purposes. It is assumed in all options that the investment portfolio owned by the limited partnership will have a 12% pre-tax annual internal rate of return.

★Option #1: Assumes a gift of 90% of a \$10.0 million partnership through a 5 year, 25% GRAT by Mr. Founder and a 10 year, 14.9% GRAT by Mrs. Founder. Upon termination of each GRAT the remainder is transferred to a non-generation skipping transfer tax trust for the benefit of Founder's children. Illustrated is the value transferred to the children after 10 years and the value returned to the Founders' estates after 10 years assuming a 12% annual internal rate of return on all assets. Under this option no generation-skipping transfer tax leverage is achieved.<sup>1</sup>

★Option #2: Assumes a gift of 90% of a \$10.0 million partnership through a combination partial outright gift and 5 year, 25% GRAT by Mr. Founder and partial outright gift and 10 year, 14.9% GRAT by Mrs. Founder. Upon termination of each GRAT the remainder is transferred to a non-generation skipping transfer tax trust for the benefit of Founder's children. Illustrated is the value transferred to the children after 10 years and the value returned to the Founders' estates after 10 years assuming a 12% annual internal rate of return on all assets. Under this option no generation-skipping transfer tax leverage is achieved. This option's results should be compared directly with Option #3.<sup>1</sup>

★Option #3: Assumes a transfer of 90% of a \$10.0 million partnership through a combination part gift/part sale by Mr. Founder to an IDGT in exchange for a 5 year note with federal mid-term interest at 6.62% and a combination part gift/part sale by Mrs. Founder to an IDGT in exchange for a 10 year note with interest at 6.40%. Such gift/sale is made to a generation skipping transfer tax trust for the benefit of Founder's children and more remote descendants. Illustrated is the value transferred to the children and more remote descendants after 10 years

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<sup>1</sup> Assumes 7520 rate of 8.0%. It is possible to leverage the generation-skipping transfer tax exemption under options #1, #2 and #4 through the sale of the remainder interest in the GRAT to an IDGT. This will increase the gift tax consequences of these options by requiring a coverage gift to the IDGT prior to the sale.

and the value returned to the Founders' estates after 10 years assuming a 12% annual internal rate of return on all assets. Under this option generation-skipping transfer tax leverage is achieved. This option's results should be compared directly with Option #2.

- ★Option #4: Assumes a gift of 90% of a \$10.0 million partnership through a 5 year, 12% GRAT by Mr. Founder and a 10 year, 10% GRAT by Mrs. Founder. Upon termination of each GRAT the remainder is transferred to a non-generation skipping transfer tax trust for the benefit of Founder's children. Illustrated is the value transferred to the children after 10 years and the value returned to the Founders' estate after 10 years assuming a 12% annual internal rate of return on all assets. Under this option no generation-skipping transfer tax leverage is achieved.<sup>1</sup>
- ★Option #5: Assumes a gift of 90% of a \$10.0 million partnership through a gift to a GST and non-GST tax trust by each of Mr. and Mrs. Founder. Illustrated is the value transferred to the children after 10 years and the value returned to the Founders' estates after 10 years assuming a 12% annual internal rate of return on all assets. Under this option generation-skipping transfer tax leverage can be partially achieved by splitting the gift and allocating Mr. and Mrs. Founders' generation-skipping transfer tax exemption.

**OPTION #1**  
**GRAT Gift – Assumptions:**

1. Mr. and Mrs. Founder will partition the 90% community property limited partnership interest and transfer their respective 45% separate property limited partnership interest to their own GRAT.
2. Mr. Founder will transfer his 45% limited partnership interest to a 5 year GRAT that pays a 25% annuity or \$787,000 annually for 5 years.
3. The underlying value of Mr. Founder’s GRAT assets is \$4.5 million and assuming the GRAT assets annually earn 12% and the GRAT pays \$787,000 annually, the value of the assets in the GRAT that are transferred to the children upon termination will be \$2,927,670.
4. Upon termination of Mr. Founder’s GRAT the assets are paid to a non-generation skipping transfer tax trust for the benefit of his children. The assets in such trust at the end of 5 more years (10 years from date of initial gift) will have appreciated an additional \$2,231,885.
5. Mrs. Founder will transfer her 45% limited partnership interest to a 10 year GRAT that pays a 14.9% annuity or \$468,350 annually for 10 years.
6. The underlying value of Mrs. Founder’s GRAT assets is \$4.5 million and assuming the GRAT assets annually earn 12% and the GRAT pays \$468,350 annually, the value of the assets in the GRAT that are transferred to the non-generation skipping transfer tax trust for the benefit of the children upon termination will be \$5,739,818.
7. The \$787,000 annual annuity Mr. Founder receives from his GRAT will return \$5,002,867 (includes 12% annual return on annual annuity after it is paid) to his estate over five years and will earn another \$3,813,894 over the next five years.
8. The \$468,350 annual annuity Mrs. Founder receives from her GRAT will return \$8,236,499 (includes 12% annual return on annual annuity after it is paid) to her estate over ten years.
9. Mr. and Mrs. Founder have used their unified credit/exemption equivalent amount.
10. The taxable gift through utilization of Mr. Founder’s GRAT is \$161,122.
11. The taxable gift through utilization of Mrs. Founder’s GRAT is \$318,974.

**Value Transferred To Children After 10 Years :**

From Mr. Founder’s 5-yr GRAT	2,927,670
Additional 5-yr Growth on GRAT Assets	2,231,885
From Mrs. Founder’s 10-yr GRAT	<u>5,739,818</u>

**Net Gift to Children After 10 Years** **10,899,373**

**Value Returned to Founders After 10 Years:**

From Mr. Founder’s 5-yr Annuity	5,002,867
Additional 5-yr Growth on Annuity Proceeds	3,813,894
From Mrs. Founder’s 10-yr Annuity	<u>8,236,499</u>
	17,053,260

**Gift Tax** <184,238>

**Net In Founders’ Estate After 10 Years** **16,869,027**

**OPTION #2**  
**Outright Gift/GRAT Gift – Assumptions:**

1. Mr. and Mrs. Founder will partition the 90% community property limited partnership interest and transfer their respective 45% separate property limited partnership interest to a non-generation skipping transfer tax trust and their own GRAT.
2. Mr. Founder will transfer his 45% limited partnership interest as follows:
  - i. 10% (\$315,000) to a non-generation skipping transfer tax trust, and
  - ii. the remainder (\$2,835,000) to a 5-year GRAT that pays a 25% annuity or \$708,750 annually for 5 years.
3. The underlying value of assets transferred by Mr. Founder is \$4.5 million and assuming that the assets annually earn 12% and the GRAT pays \$708,750 annually, the outright trust gift and value of the assets in the GRAT that are transferred to the children upon termination will be \$3,427,957.
4. Upon termination of Mr. Founder's GRAT the assets are paid to the same non-generation skipping transfer tax trust for the benefit of his children. The assets in such trust at the end of 5 more years (10 years from date of initial gift) will have appreciated an additional \$2,613,275.
5. Mrs. Founder will transfer her 45% limited partnership interest as follows:
  - i. 10% (\$315,000) to a non-generation skipping transfer tax trust, and
  - ii. the remainder (\$2,835,000) to a 10-year GRAT that pays a 14.9% annuity or \$422,415 annually for 10 years.
6. The underlying value of assets transferred by Mrs. Founder is \$4.5 million and assuming the assets annually earn 12% and the GRAT pays \$422,415 annually, the outright trust gift and value of the GRAT that are transferred to the non-generation skipping transfer tax trust for the benefit of the children upon termination will be \$6,563,468.
7. The \$708,750 annual annuity Mr. Founder receives from his GRAT will return \$4,502,581 to his estate over five years (includes 12% annual return on annual annuity after it is paid) and will earn another \$3,432,505 over the next five years.
8. The \$422,415 annual annuity Mrs. Founder receives from her GRAT will return \$7,415,849 to her estate over ten years (includes 12% annual return on annual annuity after it is paid).
9. Mr. and Mrs. Founder have used their unified credit/exemption equivalent amount.
10. The taxable gift outright (\$315,000) and through Mr. Founder's GRAT (\$145,010) is \$460,000.
11. The taxable gift outright (\$315,000) and through Mrs. Founder's GRAT (\$287,077) is \$602,077.

**Value Transferred To Children After 10 Years:**

From Mr. Founder's GRAT Assets (includes outright gift)	3,427,957
Additional 5-yr Growth on Mr. Founder's GRAT Assets (includes outright gift)	2,613,215
From Mrs. Founder's GRAT Assets (includes outright gift)	<u>6,563,468</u>

**Net Gift to Children After 10 Years** **12,604,700**

**Value Returned to Founders After 10 Years:**

From Mr. Founder's 5-yr Annuity	4,502,581
Additional 5-yr Growth on Annuity Proceeds	3,432,505
From Mrs. Founder's 10-yr Annuity	<u>7,412,849</u>
	15,347,935

**Gift Tax** <419,456>

**Net In Founders' Estate After 10 Years** **14,928,479**

**OPTION #3**  
**IDGT Gift/Sale – Assumptions:**

1. Mr. and Mrs. Founder will partition the 90% community property limited partnership interest and transfer their respective 45% separate property limited partnership interest to an intentionally defective grantor trust in a combination gift and sale.
2. Mr. Founder will transfer his 45% limited partnership interest as follows:
  - i. 10% of his 45% partnership interest (i.e., \$315,000) will be transferred by gift to a generation skipping transfer tax trust (IDGT), and
  - ii. the remainder, i.e., 90% of his 45% partnership interest (\$2,835,000) will be sold to the IDGT on a 5 year note under which the IDGT will pay principal and interest annually with a 6.62% interest rate.
3. The underlying value of assets transferred by Mr. Founder is \$4.5 million and assuming the assets annually earn 12% and the IDGT pays \$684,409 (principal and interest) annually, the value of the remaining assets in the IDGT upon satisfaction of the promissory note will be \$3,582,594.
4. The assets in the IDGT at the end of 5 additional years will have appreciated an additional \$2,731,161.
5. Mrs. Founder will transfer her 45% limited partnership interest as follows:
  - i. 10% of her 45% partnership interest (i.e., \$315,000) will be transferred by gift to a generation skipping transfer tax trust (IDGT), and
  - ii. the remainder, i.e., 90% of her 45% partnership interest (\$2,835,000) will be sold to the IDGT on a 10 year note under which the IDGT will pay principal and interest annually with a 6.40% interest rate.
6. The underlying value of assets transferred by Mrs. Founder is \$4.5 million and assuming the assets annually earn 12% and the IDGT pays \$392,518 (principal and interest) annually, the value of the IDGT upon satisfaction of the promissory note will be \$7,088,124.
7. The \$684,409 promissory note annual payments Mr. Founder receives will return \$4,347,946 to his estate over five years (includes 12% annual return on annual promissory note payments after it is paid) and will earn another \$3,314,620 over the next five years.
8. The \$392,518 promissory note annual payments Mrs. Founder receives will return \$6,888,194 to her estate over ten years (includes 12% annual return on annual promissory note payments after it is paid).
9. Mr. and Mrs. Founder have used their unified credit/exemption equivalent amount.
10. The taxable gift by Mr. Founder is \$315,000.
11. The taxable gift by Mrs. Founder is \$315,000.

**Value Transferred To Children After 10 Years:**

From Mr. Founder's IDGT Assets	3,582,594
Additional 5-yr Growth on IDGT Assets	2,731,161
From Mrs. Founder's IDGT Assets	<u>7,088,124</u>

**Net Gift to Children After 10 Years** **13,401,879**

**Value Returned to Founders After 10 Years:**

From Mr. Founder's 5-yr Note Payments	4,347,946
Additional 5-yr Growth on Note Proceeds	3,314,620
From Mrs. Founder's 10-yr Note Payments	<u>6,888,194</u>
	14,550,760

**Gift Tax** <242,700>

**Net in Founders' Estate After 10 Years** **14,308,060**

**OPTION #4**  
**GRAT Gift (Smaller Annuity) – Assumptions:**

1. Mr. and Mrs. Founder will partition the 90% community property limited partnership interest and transfer their respective 45% separate property limited partnership interest to their own GRAT.
2. Mr. Founder will transfer his 45% limited partnership interest to a 5 year GRAT that pays a 12% annuity or \$378,000 annually for 5 years.
3. The underlying value of Mr. Founder's GRAT assets is \$4.5 million and assuming the GRAT assets annually earn 12% and the GRAT pays \$378,000 annually, the value of the assets in the GRAT that are transferred to the children upon termination will be \$5,529,161.
4. Upon termination of Mr. Founder's GRAT the assets are paid to a non-generation skipping transfer tax trust for the benefit of his children. The assets in such trust at the end of 5 more years (10 years from date of initial gift) will have appreciated an additional \$4,215,110.
5. Mrs. Founder will transfer her 45% limited partnership interest to a 10 year GRAT that pays a 10% annuity or \$315,000 annually for 10 years.
6. The underlying value of Mrs. Founder's GRAT assets is \$4.5 million and assuming the GRAT assets annually earn 12% and the GRAT pays \$315,000 annually, the value of the assets in the GRAT that are transferred to the non-generation skipping transfer tax trust for the benefit of the children upon termination will be \$8,448,465.
7. The \$378,000 annual annuity Mr. Founder receives from his GRAT will return \$2,401,376 (includes 12% annual return on annual annuity after it is paid) to his estate over five years and will earn another \$1,830,669 over the next five years.
8. The \$315,000 annual annuity Mrs. Founder receives from her GRAT will return \$5,527,852 (includes 12% annual return on annual annuity after it is paid) to her estate over ten years.
9. Mr. and Mrs. Founder have used their unified credit/exemption equivalent amount.
10. The taxable gift through utilization of Mr. Founder's GRAT is \$1,715,338.
11. The taxable gift through utilization of Mrs. Founder's GRAT is \$1,249,983.

**Value Transferred To Children After 10 Years:**

From Mr. Founder's 5-yr GRAT	5,529,161
Additional Growth on GRAT Assets	4,215,110
From Mrs. Founder's 10-yr GRAT	<u>8,448,465</u>

**Net Gift to Children After 10 Years** **18,192,736**

**Value Returned to Founders After 10 Years:**

From Mr. Founder's 5-yr Annuity	2,401,376
Additional Growth on Annuity Proceeds	1,830,669
From Mrs. Founder's 10-yr Annuity	<u>5,527,852</u>
	9,759,857

**Gift Tax** **<1,275,006>**

**Net In Founders' Estate After 10 Years** **8,484,891**

**OPTION #5**  
**Outright Gift – Assumptions:**

1. Mr. and Mrs. Founder will transfer the 90% community property limited partnership interest between a generation-skipping transfer tax trust (\$2,240,000) and a non-generation skipping transfer tax trust (\$4,060,000) by gifts.
2. The underlying value of the assets of Mr. and Mrs. Founders' combined gift is \$9,000,000 and assuming such assets earn 12% annually the trust will be valued at \$31,058,482 at the end of 10 years.
3. Mr. and Mrs. Founder have used their unified credit/exemption equivalent amount.
4. The taxable gift by Mr. Founder is \$3,150,000.
5. The taxable gift by Mrs. Founder is \$3,150,000.

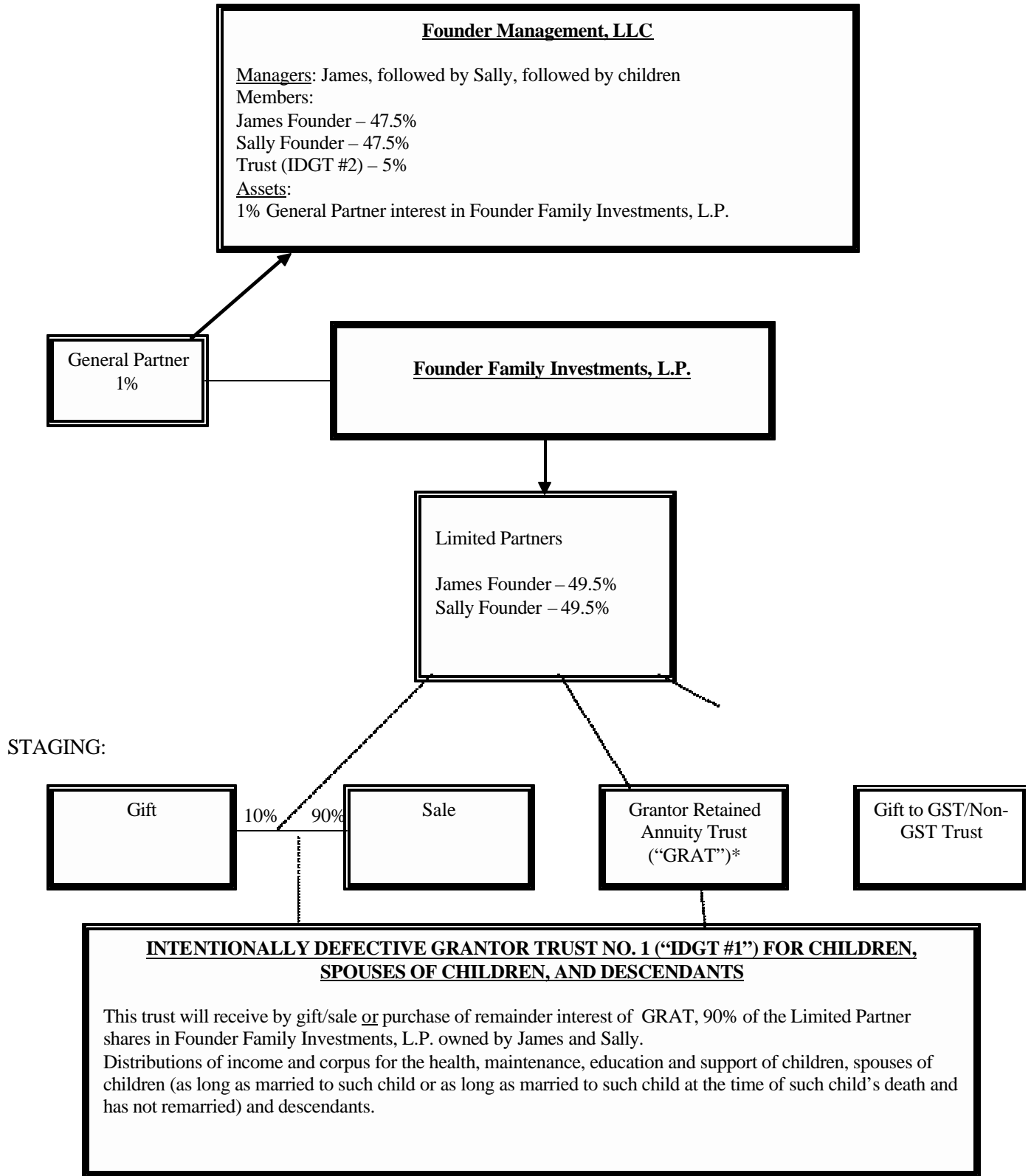
**Value Transferred To Children After 10 Years:**

<b>Net Gift After Ten Years</b>	<b>31,058,482</b>
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**Value Returned to Founders After 10 Years:**

	<b>0</b>
<b>Gift Tax</b>	<b>&lt;3,048,000&gt;</b>
<b>Net In Estate After 10 Years</b>	<b>&lt;3,048,000&gt;</b>

**JAMES & SALLY FOUNDER PROPOSED WEALTH MIGRATION SCENARIO**



\*Sale of remainder interest owned by IDGT#2 (non-GST) to IDGT#1 (GST).