LUKINOVICH LAGNIAPPE

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Sale to Defective Grantor Trusts [Case Study for Olive & Earl Breaux]

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After whetting your appetite with a primer on Grantor Trust Strategies in our July 2015 Edition of Lukinovich Lagniappe and while our oil and gas clients are continuing to navigate through tough economic times, we thought this would be a good time to bring you hope that there is a light at the end of the tunnel and promise you it is not another train.

Olive (age 50) and Earl (age 55) have been extremely successful in the oil and gas service business and have accumulated valuable real estate holdings. They have two children, a son, Earl, Jr. (age 28) who is an Assistant Professor at the University of Lafayette and a daughter, Glorious (age 26) who is a Registered Nurse. Although Earl, Jr. and Glorious are not yet married, each expects to marry and have many children and grandchildren in their future.

Olive and Earl have the following goals and objectives:

(1) To travel as much as possible and to enjoy their family as it grows.

(2) To mitigate Federal Estate Taxes and to shift income as soon as they can to their children and beyond to allow their descendants a more comfortable lifestyle.

(3) To support the Church and several private schools during life and beyond.

(4) To create a Donor Advised Fund at the Community Foundation of Acadiana so that they can be the Donor Advisors during their lives and their descendants can learn philanthropy and succeed them as Donor Advisors.

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Suggested Reading:

Napoleon Hill's Classic:

Think and Grow Rich

(First Published Nearly 90 Years Ago)

This book has inspired more entrepreneurial activity than any other.

The following is a current financial statement for Olive and Earl:

A. Cash/Cash Equivalents	$ 1,500,000
B. Integrity Services, LLC (a Sub “S” Corp)	$15,000,000
C. Real Estate Holdings	$ 5,000,000
D. Annuities and Retirement Plans	$ 3,500,000
TOTAL ASSETS:	**$25,000,000**

Currently, Integrity Services is growing at 8% per year and generating cash flow of $750,000, net of salaries/bonuses to Earl of $250,000/year. Olive and Earl generate $300,000 a year from their real estate holdings. Olive and Earl consume approximately $300,000 and make charitable donations of approximately $100,000 to schools and to the Church.

Current Annual Cash Flow Summary

(A) Distributions from Integrity		$ 750,000
(B) Salaries/Bonuses from Integrity		$ 250,000
(C) Income/Cash Flow from Real Estate Holdings		$ 300,000
	Subtotal:	$1,300,000
Less:	Federal & State Income Taxes (45%)	<$ 585,000>
	Consumption	<$ 300,000>
	Charitable Giving	<$100,000>
NET ANNUAL ACCUMULATION:		**$ 315,000**

Earl, Jr. and Glorious currently each earn $70,000/year and Olive and Earl have been subsidizing their children’s lifestyles with annual gifts of $25,000 to each of them, with after tax dollars. ***Olive and Earl would like to know if there is a more tax efficient way to move cash flow to their children.***

Olive and Earl expect to sell Integrity Services in 9 or 10 years, when Earl attains age 65, but are concerned that if they do no estate planning, their taxable estates will grow to a point where the government will get too large of a part of their life savings.

At the current rate, they have been told that their estates could double in value in 10 years, even though the federal estate tax exemptions available to them are expected only to increase by $1.5 to $2.0 million during that period under current inflation rate assumptions.

PROPOSED PLAN

Action Point 1: Convey their $5,000,000 of real estate holdings into Olive and Earl Real Estate Holdings, LLC and donate 30% of Non-Voting Membership Interests outright to each of their children, Earl, Jr. and Glorious, and donate 10% of Non-Voting Membership Interests in Trust to the Earl Family Trust No. 1 and the Olive Family Trust No. 1; Olive and Earl would retain as community property 20% Voting Membership Interests.

Result: Assuming a combined minority interest/lack of marketability discount of 33.33%, Olive and Earl will use up approximately $2,000,000 of their federal lifetime gift tax exemptions computed as follows:

Value of Real Estate Holdings	$ 5,000,000
Less: One-third (33.3% assumed discount)	<$1,666,667>
Discounted Value	$ 3,333,333
80% donated	x 80%
DONATED VALUE:	**$2,666,667**

On a going forward basis, Olive and Earl will shift $90,000 of income/cash flow to each of their children (i.e., $300,000 x 30%), increasing their children's lifestyles dramatically and utilizing their children's tax brackets which are 15% less than Olive's and Earl's tax brackets, resulting in income tax savings to the family of $27,000/year. Additionally, Olive and Earl will shift $30,000 of income/cash flow to each of their Multi-generational Defective Grantor Trusts, namely Earl Family Trust No. 1 and Olive Family Trust No. 1, illustrated under **Action Point 2** shown below.

Action Point 2: Olive and Earl will partition 70% of their stock in Integrity Services (an "S" Corporation) as follows:

Olive's Separate Property (35%)	$5,250,000
Earl's Separate Property (35%)	$5,250,000
Olive & Earl's Retained Community Property (30%)	$4,500,000
TOTAL:	**$15,000,000**

Earl will create a Multi-generational Grantor Trust, namely "Earl Family Trust No. 1" for the benefit of Olive as Primary Income Beneficiary and their descendants (down to Generation 4) and **donate** to that Trust his 35% Separate Property Stock in Integrity Services:

Integrity Services Enterprise Value	$15,000,000
X 35% Share	$ 5,250,000
1/3 Assumed Minority/Lack of Marketability Discount	<$1,750,000>
DISCOUNTED SALE/DONATION VALUE:	**$ 3,500,000**

Earl Family Trust No. 1	
Olive = Primary Income Beneficiary and Trustee	
½ Subtrust	**½ Subtrust**
Earl, Jr., Primary Income Beneficiary	**Glorious**, Primary Income Beneficiary
Earl, Jr.'s Future Children, Secondary Income Beneficiaries	**Glorious' Future Children**, Secondary Income Beneficiaries
Earl, Jr.'s Future Grandchildren, Principal Beneficiaries	**Glorious' Future Grandchildren,** Principal Beneficiaries

In order to avoid the Reciprocal Trust Doctrine, Olive will create a Multi-generational Defective Grantor trust, namely "Olive Family Trust No. 1" for the benefit of Earl, Jr. and Glorious as equal Primary Income Beneficiaries of separate Subtrusts and their descendants (down to Generation 4) and **sell** to that Trust her 35% separate property at a discounted sale price of $3,500,000.

Olive Family Trust No. 1	
Earl = Trustee	
½ Subtrust	**½ Subtrust**
Earl, Jr., Primary Income Beneficiary	**Glorious**, Primary Income Beneficiary
Earl, Jr.'s Future Children, Secondary Income Beneficiaries	**Glorious' Future Children**, Secondary Income Beneficiaries
Earl, Jr.'s Future Grandchildren, Principal Beneficiaries	**Glorious' Future Grandchildren,** Principal Beneficiaries

As a result of implementing the three estate planning strategies described above, Olive's and Earl's asset growth and income have shifted, resulting in the following estate picture at year 10. *See attached model for year-by-year figures with assumptions.*

ESTATE PICTURE AT YEAR 10

	Do-Nothing	Implemented Plan
Assets Held in Olive & Earl's Taxable Estate	$50,336,318	$18,406,628
Assets Held Directly by Earl, Jr. & Glorious		$ 5,700,733
Assets Held in Earl's Trust for Olive & Descendants		$14,999,478
Assets Held in Olive's Trust for Earl & Descendants		$11,499,478
Estate Tax Burden on Olive & Earl Breaux Family	**($14,974,527)**	**($4,669,318)**
Total Net to Heirs after Estate Tax	**$35,361,791**	**$45,937,000**
Estate Tax Savings under Implemented Plan		***$10,305,209***

(Note: Additionally, Olive and Earl's Family is projected to save $270,000 in the aggregate in income taxes (i.e., $27,000 annually x 10 years).

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Discount on Donations & Sale:	1/3	Integrity Services, LLC		Real Estate		Taxable Income, Consumption & Tax	
Current Estate Tax Rate:	40%	Value:	$15,000,000	Value:	$5,000,000	Integrity Sevices, LLC Distributions:	$ 750,000
Avg State & Fed Income Tax Rate:	45%	Annual Growth:	8%	Annual Growth:	4%	Real Estate Income:	$ 300,000
Children's Avg State & Fed Rate:	30%	Donated to Earl's Trust:	35%	Donated to Each Child:	30%	Annual Salaries & Bonuses:	$ 250,000
Current Estate Exemption:	$ 10,900,000	Sold to Olive's Trust:	35%	Donated to Each Trust:	10%	Annual Consumption & Charitable Giving:	$ (400,000)
Est. Exemption Annual Inflation:	$ 200,000	Retained by Olive & Earl:	30%	Retained by Olive & Earl:	20%	Combined Federal and State Income Tax:	$ (585,000)
						Net Annual Accumulation:	$ 315,000

Implemented Wealth Conservation Plan

	Year	Assets Retained by Olive & Earl[2]	Remaining Estate Exemption[3]	Estate Taxes	Net After Estate Tax	Donations to Earl, Jr. and Glorious[4]	Earl's Trust (DGT) for Olive & Descendants[5]	Olive's Trust (GRAT) for Earl & Descendants[6]	Total Net to Heirs	Cumulative Income Tax	Estate Tax Savings
0	2016	$ 14,000,000	$ (4,733,333)	$ 3,706,667	$ 10,293,333	$ 3,000,000	$ 5,750,000	$ 2,250,000	$ 21,293,333	$ -	$ 1,933,333
1	2017	$ 14,231,000	$ (4,933,333)	$ 3,719,067	$ 10,511,933	$ 3,246,000	$ 6,482,500	$ 2,982,500	$ 23,222,933	$ 27,000	$ 2,606,933
2	2018	$ 14,500,400	$ (5,133,333)	$ 3,746,827	$ 10,753,573	$ 3,496,800	$ 7,249,400	$ 3,749,400	$ 25,249,173	$ 54,000	$ 3,309,973
3	2019	$ 14,810,888	$ (5,333,333)	$ 3,791,022	$ 11,019,866	$ 3,752,592	$ 8,053,420	$ 4,553,420	$ 27,379,298	$ 81,000	$ 4,044,706
4	2020	$ 15,165,352	$ (5,533,333)	$ 3,852,807	$ 11,312,544	$ 4,013,576	$ 8,897,496	$ 5,397,496	$ 29,621,113	$ 108,000	$ 4,813,561
5	2021	$ 15,566,894	$ (5,733,333)	$ 3,933,424	$ 11,633,470	$ 4,279,959	$ 9,784,799	$ 6,284,799	$ 31,983,026	$ 135,000	$ 5,619,156
6	2022	$ 16,018,849	$ (5,933,333)	$ 4,034,206	$ 11,984,642	$ 4,551,957	$ 10,718,750	$ 7,218,750	$ 34,474,099	$ 162,000	$ 6,464,316
7	2023	$ 16,524,800	$ (6,133,333)	$ 4,156,587	$ 12,368,213	$ 4,829,795	$ 11,703,043	$ 8,203,043	$ 37,104,095	$ 189,000	$ 7,352,086
8	2024	$ 17,088,600	$ (6,333,333)	$ 4,302,107	$ 12,786,493	$ 5,113,707	$ 12,741,668	$ 9,241,668	$ 39,883,537	$ 216,000	$ 8,285,751
9	2025	$ 17,714,392	$ (6,533,333)	$ 4,472,423	$ 13,241,968	$ 5,403,935	$ 13,838,930	$ 10,338,930	$ 42,823,764	$ 243,000	$ 9,268,852
10	2026	$ 18,406,628	$ (6,733,333)	$ 4,669,318	$ 13,737,310	$ 5,700,733	$ 14,999,478	$ 11,499,478	$ 45,937,000	$ 270,000	$ 10,305,209

Do-Nothing

	Year	Taxable Estate[1]	Estate Exemption	Estate Taxes	Net to Heirs
0	2016	$ 25,000,000	$(10,900,000)	$ 5,640,000	$ 19,360,000
1	2017	$ 26,915,000	$(11,100,000)	$ 6,326,000	$ 20,589,000
2	2018	$ 28,942,000	$(11,300,000)	$ 7,056,800	$ 21,885,200
3	2019	$ 31,089,320	$(11,500,000)	$ 7,835,728	$ 23,253,592
4	2020	$ 33,365,920	$(11,700,000)	$ 8,666,368	$ 24,699,552
5	2021	$ 35,781,450	$(11,900,000)	$ 9,552,580	$ 26,228,870
6	2022	$ 38,346,305	$(12,100,000)	$ 10,498,522	$ 27,847,783
7	2023	$ 41,071,682	$(12,300,000)	$ 11,508,673	$ 29,563,009
8	2024	$ 43,969,644	$(12,500,000)	$ 12,587,857	$ 31,381,786
9	2025	$ 47,053,188	$(12,700,000)	$ 13,741,275	$ 33,311,913
10	2026	$ 50,336,318	$(12,900,000)	$ 14,974,527	$ 35,361,791

assets.

($1,000,000), Sale Price of 35% of Integrity Services, LLC to Olive's Trust ($3,500,000, i.e., $5,250,000 value less 1/3 discount), and $5,000,000 of other assets.

3. Under the Implemented Wealth Conservation Plan, approximately $6,166,667 of available Gift, Estate and Generation-Skipping Transfer Tax Exemption Amount is consumed by the donation of 35% of Integrity Services, LLC to Earl's Trust ($3,500,000 discounted value), the donation of 30% of Real Estate to each child ($1,000,000 discounted value, each), and the donation of 10% of Real Estate to each of Earl's Trust and Olive's Trust ($333,333 discounted value, each), for a total of $6,166,667.

4. $3,000,000 of Donations to Earl, Jr. and Glorious includes 30% of Real Estate donated to each of Earl, Jr. and Glorious ($1,500,000

5. $5,750,000 of Earl's Trust includes 35% of Integrity Services, LLC ($5,250,000) and 10% of Real Estate ($500,000).

6. $2,250,000 of Olive's Trust includes 35% of Integrity Services, LLC ($5,250,000) and 10% of Real Estate ($500,000) less Sale Price of 35% of Integrity Services, LLC of $3,500,000.

7. Because Earl, Jr. & Glorious are taxed at a lower combined average rate of 30% (15% lower than Olive & Earl's 45% rate) the income attributable to assets held directly by each of them ($180,000 of income from 60% of Real Estate held) yields an income tax savings to the family of $27,000 per year (i.e., $180,000 x 15% difference).