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TRUSTS & ESTATES

The newsletter of the ISBA's Section on Trusts & Estates

Preferred Partnership Interest Sale To Grantor Trust

By Stephen M. Margolin*

This article discusses the benefits of recapitalizing a partnership with preferred interests, and the sale of those interests to a grantor trust. The principal objects of this exercise are as follows: 1) to capture the total income from the partnership in a trust for junior family members, and 2) to lower the value of the remaining partnership interests of the senior family members.

The procedure involves the following steps:

1. Form or recapitalize a partnership to provide a preferred limited partnership interest with a 10 percent distribution preference.
2. Form or utilize an existing "grantor trust," which is defective for income tax purposes under IRC Section 671 et seq.,¹ for the benefit of descendants (and spouse, if desired) of the senior family member.
3. Sell the preferred limited partnership interest from the senior family member to the grantor trust.²

The Illustration

Assume these facts. Limited partner-

ship has \$10,000,000 of investable funds conservatively earning 5 percent³ annually, or \$500,000. Before recapitalization, the structure of the limited partnership was as follows:

Family Corporation owns a 1 percent general partner's interest;

Mr. Senior owns a 90 percent limited partner's interest; and

Mrs. Senior owns a 9 percent limited partner's interest.

Family Corporation, the general partner of the limited partnership, is owned 20 percent by each of Mr. and Mrs. Senior and their three children.

The Recapitalization

The limited partnership is formed or recapitalized so that the owners own 50 percent common interests and 50 percent preferred interests. Thus, the \$10,000,000 underlying value is split \$5,000,000 to the common interests and \$5,000,000 to the preferred interests.

The preferred interests have a preferred distribution equal to 10 percent⁴ of their \$5,000,000 capitalization, or \$500,000.

Mr. Senior's pro rata interest is 90 percent of \$5,000,000, or \$4,500,000 and his preferred interest distribution is \$450,000

(\$4,500,000 x 10 percent).

The Sale

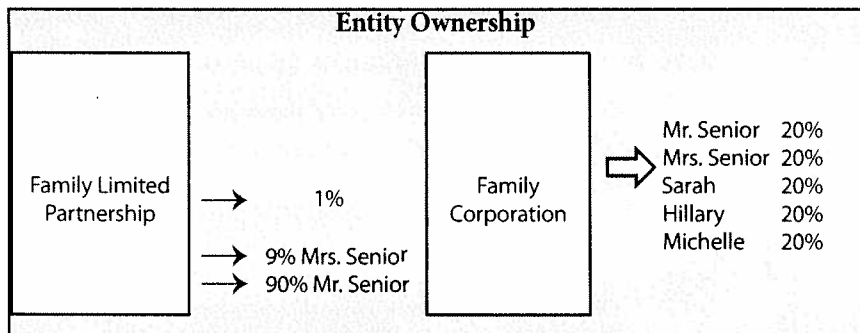
Mr. Senior wishes to sell his 90 percent preferred interest, with an underlying value of \$4,500,000, to a grantor trust, with Mr. Senior as grantor. He consults with an independent, professional appraiser who determines that these preferred interests attract a 25 percent discount, because these are non-controlling, non-marketable limited partner's interests. Therefore, the selling price is 75 percent of the underlying value of \$4,500,000, or \$3,375,000 (\$4,500,000 x 75 percent). This sale is to the grantor trust for an interest only, nine year principal balloon installment note, bearing 3.16 percent annual interest (3.16 percent is the October 2008 mid-term Applicable Federal Rate).

The Arbitrage

The 10 percent preferred preference equals \$450,000, which annually rolls into the grantor trust. Pursuant to the installment note, the grantor trust pays \$106,650 (\$3,375,000 x 3.16 percent) interest annually to the seller, Mr. Senior.

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Thus, \$343,350 (\$450,000 - \$106,650) is trapped in the grantor trust each year. This is the arbitrage difference between the coupon rate of 10 percent and the October 2008 Applicable Federal Rate of 3.16 percent. See the accompanying Exhibit.

Because the income is drained off into the preferred interests, the common interests remaining with Mr. and Mrs. Senior are more fully discounted to as much as 35 percent, according to the appraiser.⁵

Further, inasmuch as the grantor trust is defective for income tax purposes under Code Section 671 et. seq., the grantor trust bears no income tax on the \$343,350 earnings.

Further still, since the grantor of the grantor trust is Mr. Senior, his potential estate is further depleted by being obligated to pay the income tax on the funds that now reside estate tax free in the grantor trust.

The Life Insurance Opportunity

The grantor trust annual residual balance of \$343,350 could be utilized to acquire life insurance on Mr. Senior. Mr. Senior is age 75 and in good health. He qualifies for a standard universal life policy with a \$6,250,000 death benefit. The policy annual premium is \$300,000. The merit of this exercise is that the \$6,250,000 death benefit proceeds are not subject to income taxes.⁶ Importantly, the proceeds are not only out of Mr. Senior's gross estate for Federal estate tax purposes, but are not subject to estate, gift and generation taxes to his descendants in perpetuity.⁷

The Descendant's Grantor Trust

A grantor trust is a valid irrevocable trust. However, under IRC Section 671 et. seq., for income tax purposes, the grantor, Mr. Senior, is considered the owner of the trust. This means that upon his sale of his limited partner's interest to the grantor trust, the gain is not recognized, because the sale is between the grantor and himself—a non-taxable event. Thus, for income tax purposes, Mr. Senior is treated the same both before and after the transaction. However, for federal estate and gift tax purposes, this irrevocable trust is a person separate from Mr. Senior under the Internal Revenue Code.⁸

The Objects

The objects of this exercise are as follows:

The limited partners' preferred interests attract a discount of 25 percent or more of the underlying partnership value, subject to appraisal by an independent appraiser, justifying the sale of those interests at 75 percent of the underlying value.

Accumulation of \$343,350 annually in the grantor trust, because of the arbitrage of the 10 percent preferred interest rate and the October 3.16 percent Applicable Federal rate.

Avoidance of Federal estate tax (and state estate tax, if applicable) on all accumulated funds in the grantor trust.

Decrease the size of Mr. and Mrs. Senior's potential taxable estate by having them subject to income tax on the income of the grantor trust. This is a further significant gift to the trust each year, because funds in the grantor trust accumulate tax free.

Discounting the installment note in Mr. Senior's potential taxable estate, in the event the note survives him.

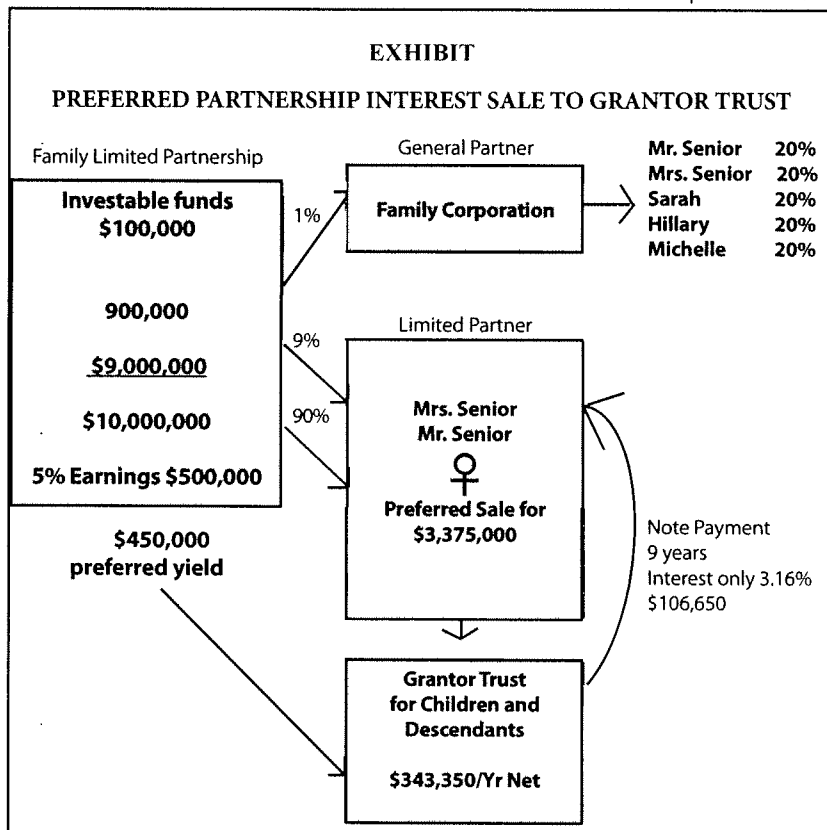
Since the preferred limited partnership interest drains the earnings from the Partnership, the common limited partnership interest held by Mr. and Mrs. Senior could be discounted 35 percent, according to an estimate by an independent, professional appraiser.⁹

Providing strong asset protection against creditor claims (including divorcing spouses) of Mr. Senior's descendants.

Attachment: The grantor trust

The grantor trust is formed by Mr. Senior contributing \$337,500¹⁰ to the trustee of the trust. This contribution goes against Mr. Senior's lifetime gift exemption, so no gift tax is payable. The purpose of this contribution is to establish the trust's independent economic substance. The terms of the trust are as follows:

- A. Mr. Senior is the grantor.
- B. Child One is the trustee.
- C. Mrs. Senior, Mr. Senior's children and their descendants are the beneficiaries.
- D. The trustee has exclusive power to distribute funds from the trust to Mrs. Senior, to himself and any other child or descendant for that beneficiary's health, maintenance, support or education. An independent, unrelated special trustee could be appointed with the power to make distributions to descendants based upon the "best interests" of the beneficiary, which is a broader standard.
- E. After the death of Mr. and Mrs. Senior, the trust divides into separate trusts



of equal value for each child then living and one trust for the then living descendants of a deceased child.

- F. The trustee could add other trustees at his discretion and can remove trustees previously designated.
- G. In the event a descendant is not distributed all of his allocated trust funds, that descendant has a power to appoint those funds to Mr. Senior's descendants and charities.
- H. If a child who dies with a remaining trust balance does not so appoint the trust assets, they will pass automatically to his or her descendants, or if none are living, to Mr. Senior's descendants.
- I. The trust contains a spendthrift provision to protect against claims of creditors. With respect to children or grandchildren, the trust provides that its assets are not subject to any claim for alimony or for the support of a spouse.
- J. The trust contains a family bank loan provision, which allows the trustee to loan the funds to whomever he sees fit.
- K. The trust has been formed under and is governed by the laws of the State of Illinois. However, because this trust splits into separate trusts for descendants who may live elsewhere, a provision allows the trustee to transfer the situs of the trust, or any separate trust, to any other state.

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1. All section references are to the Internal Revenue Code.
2. Code Section 2701 applies special valuation rules on a transfer from a senior family member to a junior family member. However, if the senior family member retains a distribution right which, under section 2701(c)(1)(B), "is junior to the rights of the transferred interest," that section does not apply. Under our facts, the retained interest is junior to the transferred interest.
3. Vanguard Long Term Bonds yield 5.46 percent, according to the August 14, 2008 issue of the Wall Street Journal.
4. On August 13, 2008, JP Morgan Chase had preferred stock selling at 8.65 percent, justifying a 10 percent, or greater, interest rate for a non-public, closely held partnership.
5. Sparadata Business Valuation Experts.
6. IRC 101(a)(1).
7. In Illinois, the statute of limitations is avoided under the Statute Concerning Perpetuities, 765 ILCS 305/4. In Florida, the statute of limitations is 360 years under the Florida Uniform Statutory Rule Against Perpetuities, Florida Statute Title XL Real and Personal Property 689.225. In California, it is a life in being plus 21 years or 90 years after its creation. California Uniform Statutory Rule Against Perpetuities, CA Probate Code §21305.
8. IRC §7701(a).
9. Sparadata Business Valuation Experts.
10. This figure is 10 percent of the \$3,375,000 sales price.

A short note on the market of opportunities

By Katarinna McBride, Editor

With stock prices bottoming out, this may be a great opportunity to make annual exclusion gifts of publicly traded stock. This can be a very valuable asset for a young beneficiary who is willing to hold on to the stock until the market recovers.

For those who cannot stomach the concept of gifts in this economy, you will have a nice opportunity to make annual exclusion gifts in 2009 when the annual exclusion will rise to \$13,000. In 2009 an individual may make tax free gifts of \$13,000 and split gifts of \$26,000.

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