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Camps, Compounds, and Cottages:
How to Keep Them in the Family

Governance Structures for Family Vacation Properties

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I. **General Considerations: Factors Influencing Entity Selection.**

“Choice of entity” is a critical consideration facing families and their advisors in planning for the intergenerational succession of the family lands. There is no shortage of options. They include the simplest form of ownership -- a tenancy-in-common among the children which may (or may not) be subject to some form of management agreement. At the other end of the spectrum there are tiered arrangements involving multiple entities, including family limited partnerships and LLCs which own the real estate, the equity of interests of which are owned by generation-skipping trusts. There are a whole universe of alternative structures involving single entities with various features which in terms of cost and complexity fall between these two extremes.

An advisor’s choice of the proper ownership and governance structures in any given case depends, of course, on a number of variables.

- ***How valuable is the property?*** Obviously, the complexity of an arrangement established for a \$5 million property comprising 500 acres with 2,000 feet of pristine lakefront, multiple structures and recreational amenities will be greater than a \$50,000 hunting camp in the woods.
- ***How many children in the next generation are interested in retaining it,*** and how many would prefer to sell it and receive liquid assets as part of their inheritance?
- ***What are the annual carrying charges*** associated with the property?
- ***Does the property have unique characteristics (such as third party rental or recreational use) which create a need for creditor protection?***

➤ ***If the property is a true “heirloom” and both the parents and their adult descendants wish to preserve it for future generations, is any special planning required to discount the value*** of the lands if their current value exceeds the GST exemptions available to the current owner or owners?

➤ ***Is there a desire or need to create a liquid endowment*** so that the property can be substantially or completely economically self-sustaining, or do the parents prefer that the descendants bear the burden of carrying charges, and if they do and also wish to use a generation-skipping arrangement, how can the children contribute and not affect the property’s GST inclusion ratio?

➤ ***Should the governing instrument allow sale, subdivision, granting of conservation easements, etc., to manage values and taxes?***

➤ ***Should members of future generations have the right to “opt out”*** of the structure by liquidating their interests in some fashion, and how can those liquidation rights be structured to avoid adverse wealth transfer tax consequences?

➤ ***What arrangement is the most income tax efficient*** if the property is rented or sold in the chosen entity?

➤ ***What structure best protects the property from dissident spouses*** in the event of an heir’s divorce, bankruptcy, lawsuits, etc.?

➤ ***If important decisions are to be made to sell, subdivide, borrow, etc., who, as between multiple stakeholders in the next and further generations, should be the decision maker*** -- particularly as future generations pass and the class of stakeholders grows?

➤ ***Who will police burden and benefit sharing*** -- satisfying annual operating cash flow deficits and determining who uses and enjoys the property and when?

➤ ***For New Hampshire properties, what are the real estate transfer tax implications*** of the strategies being considered?

All of the structures discussed in these materials have their own specific strengths, weaknesses and limitations. The trick is finding the best approach or combination of approaches which meets any specific family’s needs. You could spin hundreds of scenarios and suggest endless permutations to address them. Rather than provide a tome on these topics, these materials will provide an overview.

II. Threshold Issues.

A. Is There Both Passion and Pocketbook?

1. Passion: Identifying the “Stewards” and the “Liquidators”. The advisor must first focus the client on whether the objective of preserving the property for the next generation is realistic or a pipe dream. It is dangerous for the clients to assume that the children and perhaps further generations are as passionate about the property and its preservation as the current owners are. Have the children expressed more than a generalized interest in keeping the property in the family and using and enjoying it after their parents are gone? Do they get along reasonably well such that they can be expected to cooperate with and trust one another? Do they understand the implications -- both financial and in terms of the continual “sweat equity” it often takes to manage and maintain the property? The children may be fond of the place and have great childhood memories, but they may be busy with their careers and families, have limited financial means, or live so far away that they cannot be expected to use and enjoy the property or contribute to its upkeep.

2. Pocketbook: Filling the Money Pit.

a. Budgeting. Assuming the next generation supports the idea of succession, the advisor must next focus on the economic considerations. The client should prepare an annual budget for the property. This should include annual maintenance, property taxes, property and casualty insurance and an annual allowance for new capital improvements. Anyone who has owned substantial waterfront property knows that these places are money pits. Often there are several out buildings and aging structures which are in constant need of paint, a new roof, a new dock, etc. For example, property taxes in New Hampshire are confiscatory (at least at the moment). A client of mine with a beautiful compound on Squam Lake recently had his annual property tax bill increased to \$60,000 after a reassessment. That alone might doom any plans the client or his children has for succession. If the property is worth a few million dollars, the heirs might prefer to sell it after the parents’ deaths and reinvest their respective shares of the net proceeds in more modest vacation properties they might purchase for their individual families.

b. Where Will it Come From: Inside or Outside the Structure?
If the budgeting process does not deter the client or the heirs, the advisor and the client must formulate a plan for the payment of the annual carrying charges.

i. Consider Creating an “Endowment” for Economic Self-Sufficiency. Ask the client whether he or she is interested in creating a liquid endowment to make the property self-sustaining. Determine if there are sufficient liquid assets -- cash and marketable securities -- to set aside to establish the fund. If not, life insurance might play a role. If the client’s assets include existing insurance policies they might be transferred into an irrevocable insurance trust such that if the client survives the three year “contemplation of death” period under Code §2035 the death

benefit will not eroded by estate taxes and will be available to seed the endowment if the client does not have sufficient liquid assets to do the job. If the client is young and healthy enough, perhaps new insurance could be purchased (on a second-to-die basis for married clients) in an irrevocable insurance trust so that the three-year rule will be avoided. Insurance-based endowment funding strategies might be important especially if the client will use much of his or her unified credit and GST exemptions in transferring the property.

ii. Funding Without an Endowment. If the client is not interested in creating an endowment or is unable to do so, there are other options. The children could be forced to contribute the operating deficit pro rata or commensurate with their use and enjoyment of the property. (This becomes more difficult after the passing of the children's generation as the number of stakeholders proliferates). The children might pay rent for the use and enjoyment of the property. The property or portions of it can be rented to third parties. If the governing documents permit it, portions of the property could be subdivided and sold. The family might grant a conservation easement to reduce property taxes. It might even sell the easement to generate some cash.

To leave the door open to these options, the governing documents must be carefully drafted to specifically grant the managers of the owner entity the power to take the required actions. This is particularly true of a conservation easement which will reduce the fair market value of the property. Without enabling language in a trust agreement, a trustee's gift of a conservation easement to a qualified conservation organization which is not a beneficiary of the trust will depress the economic value of the property and subject to the trustees to surcharge for breaching their fiduciary duties to protect and preserve the value of the trust property.

B. Lifetime or Deathtime Transfer? Assume that your discussion of the passion and the pocketbook issues has not totally discouraged the client. Now you must help him or her to decide whether to make the irrevocable transfer now or upon death.

1. The Benefits of Lifetime Transfers. Generally, those clients choosing a lifetime transfer do so to minimize gift and estate taxes. Families facing little or no estate tax exposure will usually plan for a deathtime transfer so that the parents can continue to use the property rent-free until their deaths. A deathtime transfer will also allow the children or the chosen management vehicle to receive the property with a fully stepped-up basis under Code §1014 because the property will be included in the client's gross estate for estate tax purposes upon the client's death¹, whereas a donee

¹ A discussion of Medicaid planning transfers is beyond the scope of this program. Provisions in the Medicaid laws apparently allow an uncompensated transfer of a residence to a caregiver child if that child had provided care for a period of time which allowed the parent to stay in the residence and prevented the parents' institutionalization, thereby deferring the need for public assistance. I understand that such transfers do not trigger a disqualification period and avoid the imposition of a Medicaid lien which might otherwise have attached. If an advisor is considering such a transfer, the deed to the caregiver child can be drawn to reserve to the parent modest powers, such as a right to make rent-free use of the property during one month of the year or a right to determine who can use and enjoy the property,

of a lifetime gift will take his donor's "carryover" basis under Code §1015.

Despite the loss of the basis step-up, however, structuring the transfer during the client's life can save a bundle in gift and estate taxes for several reasons.

- For vacation properties that can be expected to appreciate in value, the transferor will "**freeze**" **the transfer tax value** at current (hopefully discounted) values such that future appreciation accrues outside the client's taxable estate. As we have seen in the very recent past, high-end vacation properties, particularly with water frontage, have appreciated at a rate greater than the appreciation rates for generic residential properties, which historically have not enjoyed appreciation of a rate that much greater than the CPI.
- By fractionalizing the property and/or packaging it in a discounting wrapper such as an LLC or an FLP, **greater valuation discounts can often be taken for lifetime transfers.**
- Presuming the client makes "adequate disclosure" of the basis for the discounts on a gift tax return, **the client making a lifetime gift can get the benefit of the three year gift tax statute of limitations.** History and experience tell us that the IRS is less likely to challenge valuation discounts reported on gift tax returns than those reported on estate tax returns.
- If the client uses outright gifts of undivided interests or indirect interests in an entity which holds real estate (FLP or LLC), and/or a crummey trust, **the client can use annual exclusions**, now \$12,000 per donee, to minimize the consumption of the unified credit exemption. This advantage can be especially compelling for married property owners with multiple descendants and spouses who might, for example, be discretionary beneficiaries of a donee irrevocable trust and have interests which are sufficient under the Cristofani standards to support the bona fides of their withdrawal rights.
- Although this is a harder sell now for clients who hope after EGTRAA that the wealth transfer taxes will eventually be phased out, **the assessment of gift taxes on a lifetime transfer exceeding the unified credit amount will benefit from tax exclusivity**, versus an estate tax on the same transfer which would be assessed on a tax inclusive basis, assuming the client survives for the three year "contemplation of death" period following his or her gift.

2. The Disadvantages to Lifetime Transfers. Structuring properly to secure these benefits can be quite costly. Professional fees will not only include your legal fees, but appraisal costs as well. Clients using FLPs or LLCs as the title-holding vehicle must pay both the real estate appraiser to determine the value of the underlying

which would rise to the level of a "retained interest" under Code §2036 and §2038. This will enable the caretaker/donee child to sell the property after the parent's death with little or no capital gain tax liability -- assuming, of course, that the child does not sell the property prior to the parent's death.

property and then pay a second business valuation professional to determine the fully discounted value of the LLC member or FLP limited partner interests transferred. Combined appraisal fees can be in the range of \$5,000-\$10,000. A cost often overlooked is the real estate transfer tax payable for properties transferred to an LLC or an FLP. Under the New Hampshire real estate transfer tax statute, a transfer to an entity with transferable interests is deemed a taxable sale. The consideration received in the form of the LLC member units or FLP limited partner interests is presumed to be equal to the fair market value, unreduced by any mortgage indebtedness, of the property transferred. The rate of tax is 1.5%. A property worth \$1.5 million will attract a transfer tax of \$22,500. All things considered, the client's costs for the year of the structuring (including legal fees) could exceed \$50,000. Add to this the additional accounting and record keeping, including additional tax returns for the entities, etc. And the client must also have wherewithal in most situations to pay fair rental value for any continued occupancy of the residence after the date of the transfer. Any post-transfer rent-free use will give an auditor a basis for including the property in the client's estate under Code §2036(a)(1) on the basis that the client and transferee had an implied agreement that the client would enjoy an implied life estate in the property.

The advisor and client must consider these costs and compare them to the benefits to be achieved the lifetime structuring. For high-net worth clients with extremely valuable property, it was much easier before EGTRAA to make the case that the potential estate tax savings far outweighed the costs. This was particularly true for clients motivated by a deep emotional investment in and family identity with a truly special asset.

I find, however, that EGTRAA has taken some of the luster off of the estate tax savings benefits -- except for those land owners who due to age or infirmity do not expect to survive EGTRAA's transfer tax phase out period, or realistically conclude that in the current climate, Congress cannot afford to eliminate wealth transfer taxes. I encourage my clients to be cynics about wealth transfer tax reform and to make their transfers now as the only means of hedging their family's bets against an uncertain future.

III. Selected Strategies.

A. Tenancy-In-Common, With or Without a Management Agreement. Giving the kids the property in equal (or even unequal) shares as tenants-in-common either during lifetime or upon death is obviously the simplest solution. The advisor can prepare a management agreement which establishes the ground rules for co-ownership, including benefit and burden sharing, restrictions on transferability, restrictions on the use and development of the property, etc. One of several children can be designated as the sole property manager. The children as co-owners could sign it and agree that they would not amend or revoke it without their unanimous written consent. Be aware, however, that unless restrictions are imposed in a deed or other instrument recorded at the Registry of Deeds, conveyancers will tell you that rights of first purchase and refusal, etc., will be unenforceable against a bona fide third party

purchaser, pledgee, attaching creditor or dissident spouse.

1. Advantages. Simplicity, cost efficiency, and “fractional interest” discounts are available if the transfers are made during lifetime. Discounts are available for each fractional interest transferred to a co-owner because they reflect the co-owner’s inability under the laws to sell, mortgage, develop, etc., the property without the consent and participation of the other co-owners. This justifies marketability discounts, and discounts for lack of control similar to the minority discounts applied in the limited partner/non-managing member/minority shareholder context.

The IRS’s position was that the fractional interest discount is limited to the costs of prosecuting a partition action in the local court with jurisdiction over such actions (in New Hampshire -- the probate court for the county in which the property is located). The courts have disagreed and have found more credible a taxpayer’s valuation report which considers not only costs of partition, but delays associated with partition actions and “comparables” -- real estate investment trusts and the like.² The Tax Court has approved appraisal-supported fractional interest discounts of between 25 and 60 percent depending on a number of variables such as the number of co-owners, the existence of deed restrictions or mortgage debt, and others.

The cost of a full-blown fractional interest appraisal can be prohibitive. For clients who are especially fee sensitive, we have reported discounts on the low end of the spectrum -- 15%, without a formal appraisal, but with a stated rationale for the discount and citations to relevant Tax Court cases. Be sure that the gift tax return claiming a 15% discount unsupported by an appraisal meets the “adequate disclosure” requirements of the regulations and commences the running of the gift tax statute of limitations.

2. Disadvantages. You get what you pay for. The flip side of simplicity and cost efficiency is less-than optional valuation discounts and creditor protection, and limited centralization of ownership and management control. A management agreement can address some of these issues, but as indicated earlier, cannot be enforceable against third party predators without knowledge of the restrictions. A co-owner’s interests are subject to attachment and division upon divorce. I have seen heard anecdotally about a dissident family member co-tenant who sells or threatens to sell his or her undivided interest to a developer to effectively extort from the other co-owners a settlement involving a cash payment or the subdivision and development of a portion of the property. There exists the possibility of deadlock and disagreement concerning the ownership, management, use and enjoyment of the property. These problems become more acute as generations pass and undivided interests fall to heirs in the next generation. This gradual further decentralization of ownership creates a whole host of problems which can quickly become unmanageable

² In fact, in the recent Baird case, the Fifth Circuit Court by Appeals found that the Tax Court abused its discretion in refusing under Code §7430 to award the taxpayer the litigation costs incurred in defending the IRS’ rejection of fractional interest discounts based on the discredited costs of partition analysis. See Baird Estate v. Commissioner, 416 F.3d 442 (5th Cir. 2005).

and force a sale of a property despite the wishes of what might be a majority of even a super majority of co-owners.

B. QPRTs. A “qualified personal residence trust” is an arrangement which under Code §2702 is specifically exempt from the “split interest” valuation rules of Code Chapter 14, the “anti-freeze” rules. I am posting on my website various form documents and memoranda I have prepared which describe the “regular” and “split purchase” QPRT strategies, respectively, in some detail.

1. Regular QPRT.

a. Advantages. The primary advantages are: (i) discounting the value of the gifted remainder interest by the actuarial value of the retained term and reversionary interest -- a benefit which is not as great now with the Code §7520 discount rate at a historically low level; (ii) for the client who feels he or she cannot afford paying rent for continued occupancy, deferring the vesting of the children’s or following trust’s remainder interest and the client’s obligation to pay fair rental value for continued use, and (iii) because the QPRT is a complete grantor trust under Code §671 et. seq., income tax transparency during the retained use term such that the client gets the benefit of income tax deductions for the payment of property taxes (and mortgage interest as well, although I generally do not recommend that mortgaged properties be transferred to QPRTs).

b. Disadvantages. Disadvantages include the “mortality risk” that the client will not survive the rent-free term, vesting the client’s retained reversionary interest and, because the property will be included in the client’s gross estate under Code § 2026(a), eliminating any wealth transfer tax benefit from the strategy. To avoid the implied life estate issue and §2036(a)(1), the client must be ready to lease the property from his or her children or the following grantor trust upon the expiration of the defined QPRT term. QPRT regulations which became final in May, 1996, now prevent the QPRT grantor, spouse, grantor trust created by the grantor or the spouse, and other related parties from purchasing the residence from the QPRT either prior to the expiration of the QPRT term or from a continuing grantor trust created to hold the property after the QPRT term. This takes out of play the “bait and switch” strategy of repurchasing the property from a grantor trust either immediately prior to or after the expiration of the term of years. The client cannot any longer secure both the transfer tax benefits of the QPRT strategy and the basis step-up for the property which would be available if the property were included in the client’s gross estate upon death.

2. Split Purchase QPRT.

a. Advantages. The split purchase QPRT memoranda available at www.mckan.com describe how the split purchase QPRT strategy is available for new residence split purchased by a specially-designed QPRT to which parents contribute a portion of the property’s purchase price equal to the actuarial value of a joint life estate, and the children (or a trust for their benefit) contribute the actuarial

value of the remainder interest following the expiration of the parents' joint life estate. The split purchase QPRT then enters into the P&S as buyer and completes the purchase of the property. The parents have a right to live in the property rent-free for their lives without any mortality risk (no reversionary interest or retained interest problem under 2036(a)(1) or fair rental value obligation.

b. Disadvantages. The split purchase QPRT can work well for newly acquired properties, provided they do not depreciate in value. Beware, however, that split purchase QPRTs created now with the currently low §7520 rates are more prone to backfire in the sense that they create a greater risk that the children or their trust will overpay for their remainder interests, and the parents will underpay for their life interests, than they would if the §7520 rate was closer to its historic norm.

3. Generation-Skipping Considerations With QPRTs. A regular QPRT is a lousy generation-skipping vehicle. The grantor's retention of the term of years and reversionary interests will create an "estate tax inclusion period" ("ETIP") for the duration of the defined term of years. Under the GST rules, the grantor cannot allocate GST exemption until the ETIP's closure, and then must do so against the fully appreciated, undiscounted (unless the QPRT owned a fractional interest) value of the family lands. This prevents the client from using the QPRT to leverage his GST exemption in the same fashion he uses the "up front" split interest valuation rules to value the remainder interest and thereby leverage the unified credit exemption.

The split purchase QPRT can be an attractive generation-skipping strategy if the purchase price for the remainder interest comes from an irrevocable generation-skipping trust – assuming the property appreciates in value or the parents die prematurely such that the purchase of the remainder interest proves to be a good investment of the trust's cash.

C. Family Limited Partnerships and Limited Liability Companies.

1. FLP or LLC? While these materials discuss both FLPs and LLCs as if they are sui generis, I prefer to use LLCs for estate freezing and discounting transactions because: (i) the member or non-member manager of an LLC will have liability protection, whereas without an S corporation or LLC general partner the FLP general partner will not; (ii) having a non-member manager of an LLC allows managerial control to be completely decoupled from equity ownership, whereas a general partner must always own some equity interest; (iii) an FLP must always have at least two equity owners, and must file a 1065 annually, whereas states' laws recognize single member LLCs, bringing "disregarded entity" status into play -- something which can make administration and tax compliance easier when the LLC member units are owned during the client's lifetime by the client and the client's irrevocable grantor trust -- a common estate planning structure, and (iv) most importantly, many states' LLC Act's "default rules" are at least as "Chapter 14 friendly" as those of that states' limited partnership Act, so that optional discounts can be obtained with the LLC and the "applicable restriction" rules of Code §2704(b) can easily be avoided.

2. Advantages.

a. Creditor Protection. A substantial family compound owned by an FLP or an LLC will be protected from “outside” liabilities, including claims, lawsuits and divorces of the equity owners. A creditor of an LLC member or limited partner cannot become a substitute limited partner or member under the “default” rules of the many states’ LLC and FLP Acts without the consent of the other partners or members. Instead of becoming a substitute member or limited partner, that attaching creditor is entitled only to a “charging order” against the debtor’s member or LP interest. This gives the holder of a charging order only what I refer to as “distribution rights” -- the right to receive distributions under the partnership or operating agreement as declared by the manager or general partner, without any voting, liquidation or other rights enjoyed by limited partners or members under the governing instrument or the governing state’s law. Limited partners’ and members’ personal assets are also protected from “inside” liabilities associated with the entity’s property. This could be important for family compounds subject to conservation easements or enrolled in the situs state’s current use property tax program where third party recreational or other use might be required, creating the risk of premises liability.

b. Centralization of Ownership. Vesting record and legal ownership in a single entity, and arranging for heirs or donees to hold indirect interests in the entity, and not the underlying property itself, avoids the managerial and other problems of a decentralized structure such as a co-ownership arrangement. I like to use non-member managed LLCs and have one representative of the family serve as manager on a rotating basis so that there are not too many cooks in the kitchen. It is clear under the FLP and LLC acts of most states that limited partner and LLC member interests are intangible personal property and that the limited partners and LLC members do not own undivided interests in the LLC’s or FLP’s underlying assets. This is one of the reasons it is sometimes said that the limited partnership and LLC laws represent a blending of the “entity” and “aggregate” characteristics of corporations, on the one hand, and co-owners or general partners, on the other.

c. Income Tax Efficiency. The “check the box” regulations allowing elections in or out of partnership tax treatment avoid the vagaries of the old Kintner regulations under Code §7701. The owners of FLPs and LLCs can now achieve certainty in their income tax classification by affirmatively choosing partnership tax treatment or doing nothing at all because partnership tax treatment for multi-member LLCs and FLPs is now the default rule. This avoids the potential which existed under prior law that an FLP or an LLC could be taxed as an “association” under the Kintner regulations. Associations taxed as corporations are subject to two levels of taxation: one at the entity level when income is earned or gains are realized, and upon liquidation as well, with the second tax at the owner level as distributions are made in the form of dividends or liquidating distributions. Also, as I mentioned earlier, unlike FLPs which must have more than one partner, single member LLCs can be created under most states’ LLC acts and will be treated as “disregarded entities” for federal income tax

purposes, eliminating the need for even a partnership tax return.

3. Disadvantages.

a. Cost and Complexity in Establishing and Maintaining the Entity. There will be costs in preparing an Operating Agreement and filing the Certificate of Formation or Limited Partnership Articles with the Secretary of State's Office. Ongoing care and feeding includes careful documentation to maintain the entity's legal existence. Sloppy administration, "commingling" of assets and personal use of the entity's assets without paying fair rental value will create the risks of a loss of limited liability protection. Failure to observe formalities could also provide the IRS with the basis to challenge discounts. Generally, in its challenges to discounts taken for gifted LLC member or FLP interests, the IRS has not succeeded in its "technical" arguments under Chapter 14, or its efforts to find gifts on the entity's formation. It has had some limited success in applying Code §2036 to FLPs where the former property owner who contributed his or her property to the LLC or FLP makes rent-free use of that property, commingles his personal assets with the entity's assets, or otherwise fails to respect the LLC's or FLP's separate existence.

b. Audit Risk. Make the client aware that FLPs and LLCs holding only "personal use" assets, or a combination of personal use and cash and/or portfolio assets, are especially prone to IRS challenge. The client should expect an audit and be prepared to incur the expense of defending it.

c. Local Real Estate Transfer Tax Liabilities. This is discussed in more detail above. As I said in that discussion, under New Hampshire law any transfer of New Hampshire real estate to an LLC or an FLP is deemed a taxable exchange, with the LLC member units or the limited partner interests received in return for the real estate deemed to have a value of the fair market value of the property transferred, unreduced by any mortgage indebtedness. The rate of taxation is now 1.5%. I find that this disadvantage alone is often a deal breaker for New Hampshire properties. This problem may be unique to New Hampshire real estate. You should check the situs state's transfer tax law (if any) to determine whether this will be an added cost of the structure you are avoiding.

d. Vulnerability of External Limited Partner or LLC Member Interests, and Inability to Generation-Skip Without Further Planning. The charging order as the LLC members' or limited partners' creditors' sole remedy does provide good protection of the compound from outside claims. Provisions in every well-drafted limited partnership or LLC operating agreement will preclude acceptance of substitute equity owners without unanimous member or partner consents, avoid giving members or limited partners put or liquidation rights, and impose other transferability restrictions which will prevent unwanted third parties from having voting rights or otherwise interfering with the ownership and operation of the property.

There is still, however, the possibility that a creditor, bankruptcy trustee or dissident spouse could wind up with a charging order and distribution rights. This will be a problem because to avoid technical income tax and gift tax “gift on formation” issues, most estate planning FLP agreements and LLC operating agreements require that any distributions from the FLP or LLC to the partners or members be made pro rata among them -- i.e., according to their percentage interests. An LLC manager or FLP general partner looking to starve out a holder of a charging order must also starve out the other members or partners because the general partner or manager cannot generally make distributions to some and not others. Moreover, the law involving charging orders is still evolving and could change in the future. And if the client gifts LLC or FLP interests directly to the next generation (as apposed to a trust for their benefit) the heirs or donees have acquired an asset which will be subject to estate taxation upon their later deaths (albeit at a discounted value).

To address these issues, many of my clients use “tiered” structures involving a generation-skipping trust’s ownership of the LP or LLC member interests. These trusts are typically designed as fully discretionary and provide an added layer of insulation against outside creditors. They will also be engineered for generation-skipping so that the same leveraging benefits of the discounting achieved with respect to the client’s (and possibly spouse’s) unified credit applicable exemption amount will apply to the GST exemption (\$1.1 million this year per person), with the only difference being the ineligibility of the crummey withdrawal rights for the GST annual exclusion. The tiered structure is discussed in more detail in Paragraph H, infra.

D. Common Law Trust Arrangements, Including Generation-Skipping Trusts. By “common law trust”, I mean a true trust involving the traditional trustee/settlor/beneficiary relationship and all of the attributes of that relationship as described in treatises such as Scott, Bogert, Trusts and Trustees, and the Restatement of the Law of Trusts. The true or common law trust is to be distinguished from realty and business trusts with transferable beneficial interests, which are properly characterized for local law and tax purposes as “associations” or partnerships, and “nominee trusts” which are properly treated either as general partnerships or agency arrangements among co-owners. Realty and business trusts and nominee trusts are discussed in Paragraphs E and F below.

Unlike partnerships, LLCs and corporations, common law trusts have not generally been used for the management, ownership and control of business assets requiring active management. Rather, the common law trust has its roots in feudal England as a mechanism originally designed to hold lands and protect them against escheat and the restrictive laws of descent and distribution. Trust law has crystallized over the last few hundred years, and is characterized primarily by the unique fiduciary relationship between the trustee and the beneficiary. The trustee holds title to the trust property and must manage it for the exclusive benefit of the beneficiaries under terms and conditions described in the grantor’s trust agreement. A well-developed body of default rules, both statutory and common law, determines relative rights, responsibilities, powers and duties of both trustees and beneficiaries where the trust

document is silent or makes provisions which offend public policy.

A trust is primarily a vehicle for the maintenance and conservation of “use” property, such as residential real estate, and financial assets (primarily stocks, bonds and cash). While common law trusts are not usually used to own and operate an active business, they often own non-managing equity stakes in closely-held businesses operated in the traditional forms for business organizations -- again, primarily corporations, LLCs and partnerships.

1. Advantages. Given its historical role as a management vehicle for use assets such as residential real estate, the true trust is often an entity of choice for family lands. Ownership, control and management of the property is centralized in the trustee. Trust law protects the trustee from manipulation by overreaching beneficiaries by giving the trustee a wide berth in the exercise of discretion and protecting the trustee from personal surcharge except for breaches of fiduciary duties involving loyalty (the avoidance of self dealing) or management in a manner inconsistent with the terms of the trust agreement. The trustee can provide for the payment of carrying charges associated with the property and regulate the beneficiaries’ use and enjoyment of the lands. Although the trustee is legal titleholder, the trustee’s personal assets are largely protected against attachment by creditors (including judgment creditors) of the trust. Beneficiaries likewise enjoy protection from inside liability, provided that there is no basis to proceed against the beneficiary in his or her personal capacity. Trusts can either exist as a common “family pot” for the benefit of a broad family group, such as a landowner’s descendants. In pot trust arrangements it is typical to give the trustee broad sprinkle powers over trust net income and principal, including the right to regulate use and enjoyment of family lands and impose conditions on that use and enjoyment, such as the payment of carrying charges or rent. Or the trust might split into separate shares on a per stirpital basis with each subtrust owning undivided portions of the property as tenants-in-common.

A beneficiary’s interest in true trust can be defined to make it attachment-proof and qualify for generation-skipping. The fully discretionary trust -- a non self-settled trust with respect which a third party trustee has absolute discretion over distributions of income and principal to a single beneficiary or class of beneficiaries -- is the most creditor-safe structure available. A beneficiary cannot compel the trustee to exercise the discretion in the beneficiary’s favor. No one claiming through the beneficiary -- be he an attaching creditor, divorcing spouse seeking a property settlement, bankruptcy trustee, or another -- can compel a distribution. A cooperative trustee can offer the beneficiary the rent-free use of trust real estate without any federal income tax consequences to the beneficiary. The trust agreement may give the beneficiaries liberal power to remove and replace the trustee if he or she is uncooperative, although those powers must be circumscribed to avoid adverse transfer tax results if generation-skipping is desired. Upon the beneficiary’s death, he or she can possess broad powers of appointment to direct the disposition of the trust property under the terms of the beneficiary’s will. Generation-skipping trusts must use non-general powers of appointment which preclude the beneficiary from exercising the power in favor of his or

her estate, creditors or the creditors of the beneficiary's estate.

I tell my clients that a well-designed "beneficiary controlled" trust can give the beneficiaries all of the benefits of property ownership -- use and enjoyment when it comes to the family lands -- without the burdens of vulnerability to creditors or the estate taxing authorities upon the beneficiary's death. Another advantage for New Hampshire real estate: a gift of valuable real estate to the true trust (again, one without transferable beneficial interests) is exempt from the New Hampshire real estate transfer tax. This gives the trust a leg up over the FLP and LLC structures as the property ownership vehicle for New Hampshire family landowners. While the FLP and LLC offer deeper discounts, a client and perhaps the client's spouse can gift fractional interests to the trust, and with an appraisal achieve discounts which might be in the range of 20-25%. A trust with crummey powers can secure multiple annual exclusions without fractionalizing the property or transferring multiple indirect interests (limited partner or LLC member interests) among a broad universe of donees, such as spouses and grandchildren, the client might not be ready to benefit. A sprinkle trust authorizing discretionary distributions to and use of property among all of the grantor's descendants and their spouses should support annual exclusions for all crummey powerholders in that class under the Cristofani and Kohlsatt standards.

2. Disadvantages. a. Lower Discounts. While a client's and/or the client's spouse's gifted fractional interests to the trust will secure fractional interest discounts, they will probably not equal the 40-45% discounts appraisers are now reporting for limited partner and LLC member interests (although they can be as high as 35-38%). The trustee of a trust is theoretically more vulnerable to beneficiary litigation than an LLC manager or an FLP general partner. If challenged, a trustee's actions will be judged by fiduciary standards which are less forgiving than the "business judgment rule" applied to the decisions and actions of LLC managers and FLP general partners.

I have found, however, that this concern can be addressed through drafting provisions granting the trustee broad discretion and protecting the trustee from liabilities for good faith exercises of that discretion.

b. Income Tax Rules of Subchapter J; Compressed Income Tax Rates Applicable to "Complex Trusts" DNI.

i. The Problem. Depending upon how they are administered and the extent of a trust's income and taxable gains, the rules of trust income taxation can produce higher income taxes if the income or gain were generated by an LLC or FLP, or realized by co-tenants. As a general rule, FLPs and LLCs are treated as conduits for federal income tax purposes. Their income and gains pass through to their equity owners via forms K-1 and are generally split among the limited partners or members according to their percentage interests.

By contrast, an irrevocable, non-grantor trust is taxed under one of two alternative regimes. "Simple trusts" which require the distribution of all of their income

at least annually are in the main treated as conduits and all of the trust's net tax accounting income is reported by the income beneficiary or beneficiaries. "Complex trusts" which authorize accumulations of income are taxed as modified conduits. If distributions of trust income or principal are made during a tax year or within 65 days of its close, those distributions bring with them all or a portion of the trust's "distributable net income" ("DNI") and are taxed through to the beneficiary. Trusts making no distributions during the taxable year or the 65 day grace period, or making distributions in amounts less than the trust's DNI, will pay income tax at the trust level. The trust income tax brackets are steeply graduated relative to those applied to individuals. The maximum tax rate (roughly 38% this year) applies at approximately \$10,500 of a complex trust's taxable income. By contrast, an individual does not reach that maximum income tax bracket until his or her taxable income reaches \$250,000, indexed. Capital gain is always taxed on the trust's tax return, and does flow through to the beneficiaries via forms K-1 (except for certain "private unitrusts" which, pursuant to state law, require that a beneficiary's unitrust distribution consist of all or a portion of the trust's capital gains).

ii. Getting Around the Problem. This trust income tax regime of Subchapter J of the Code can cause problems for complex trusts which have DNI and short-term capital gains taxed on the trust's return. Most trusts designed to hold family lands (particularly generation-skipping arrangements) will not be mandatory income trusts, so as complex trusts they will face this income tax problem. However, the problem is easily managed. (A) The Income Distribution Deduction. One way to do it is to keep the complex trust's ordinary income -- interest, dividends and net rents and short-term capital gain -- to a minimum. This should not be a problem for most land trusts unless they generate large amounts of net rental income or income from timbering operations, and/or they have a significant liquid endowment which produces a lot of interest and dividend income. If at the end of the year it appears that substantial ordinary income will be trapped on the trust's tax return, the trustee can make a discretionary distribution to the beneficiaries during the 65 day grace period and "zero out" the trust's DNI.

(B) Use a Grantor Trust During the Grantor's Lifetime. Use of a grantor trust during the grantor's lifetime will also avoid the problem. A "intentional grantor trust" is an irrevocable trust to which completed gifts are made for gift and estate tax purposes, but which remains the "alter ego" of the grantor for federal income tax purposes. Achieving grantor trust status is as simple as giving the trust's grantor some innocuous grantor trust power, such as an administrative power under Code §675, which triggers the grantor trust rules but does not rise to the level of a retained interest under Code §2036 or §2038. I like to use the "powers of substitution". This is a power retained by the grantor in a non-fiduciary capacity to substitute his own assets for the trust assets of equivalent value.

Achieving grantor trust status will allow all of the trust's tax attributes to drop to the grantor's 1040 during the grantor's lifetime. It will allow the grantor to lease the family lands back from the trust under a triple net lease agreement. The carrying charges (property taxes, insurance, etc.) the grantor is obliged to pay under the lease

will not be gifts to the trust because they are imposed under a bona fide contract between the grantor and the trust. This will avoid the cash flow drain of the trust paying carrying charges during the grantor's lifetime, and avoid the need for periodic gifts to pay carrying charges if the trust is not sufficiently endowed to do so on its own. The rent the grantor pays is not taxable income to the trust by the grantor because, under the authority of Rev. Rul. 85-13 and several tax cases, one cannot enter an income taxable transaction with him or herself. Because the trustee will not be burdened by carrying charges, and because the trust will retain rent dollar for dollar without erosion by income taxes, the trustee can invest the rent in an insurance policy on the grantor's life or otherwise invest it to produce an endowment which might make the trust self-sustaining as after the grantor's death.

3. Governance. A trust agreement is like putty in the hands of an experienced and imaginative drafter. The advisor can craft governance provisions and beneficiary rights and responsibilities which address many of the unique desires of land owner families. A copy of a specimen "Family Land Preservation Trust" ("FLPT") is available for download at www.mckan.com. I have designed the FLPT to provide for the appointment of a "administrative Trustee" who will handle day-to-day administration and supervise the enjoyment of the property. A "board of trustees", one representing each branch of the family headed by a child of the original landowner, will form a overarching governing body which will possess other powers, such as major decisions relating to the development, subdivision, sale or borrowing against the property, and granting conservation easements, and will have the power to remove and replace the administrative trustee. The individual subtrusts initially established on a per stirpital basis with respect to the grantor's children do not further subdivide regardless of how prolific the branches of the family are relative to each other. The trust grants the separate subtrusts and even individual beneficiaries certain "put" rights which are designed simultaneously to (i) allow a cashing out of a "liquidator's" indirect interest in the family lands in a manner designed to avoid frivolous exercises of put rights and cripple the trust with an immediate liquidity crisis, while (ii) still allowing for generation-skipping.

My Rube Goldbergian FLPT creation is explained in more detail in the summary, memoranda and article which are also available for downloading at my website.

E. Nominee Trusts. A nominee trust is a trust in name only. The trust document typically uses the words "grantor" "trustee" and "beneficiaries". The trustee holds legal title to the property and can take action only on the written direction of the beneficiaries. The trustee has no fiduciary duties and is protected from liability for any action taken at the instruction of the beneficiaries. A nominee trust is really a form of tenancy-in-common with a management agreement. Nominee trusts should not file trust income tax returns, Forms 1041. Rather, they can be treated as a co-ownership or general partnership, and no return or a 1065 can be filed. The nominee trust offers no liability protection to the "beneficiaries". It is usually revocable at the will of the beneficiaries. It has the same advantages and disadvantages as the tenancy-in-common with management agreement discussed above.

F. Realty and Business Trusts With External Beneficial Interests. These are often referred to as “Massachusetts” realty trusts, or “Illinois” business trusts. While they vary somewhat in their design, their distinguishing feature is a schedule of beneficial interests, or even certificates of beneficial interests, assigning ownership percentages to each “beneficiary”. Most often the interests are transferable. These arrangements may also be characterized as trusts in name only. Depending on their particular features, they are often properly characterized and analyzed as general partnerships or as associations taxable as regular corporations. I do not like to use them because their nature under local law is uncertain. Are the legal rights and responsibilities of the putative beneficiaries and trustee to be governed by the Uniform Partnership Act or the corporation laws? A lot of the uncertainty concerning their federal income tax character has been removed since the promulgation of the “check the box” regulations. Under prior law, the §7701 regulations would apply to classify most of these arrangements as associations taxable as corporations. This created the real risk of two levels of income taxation under the regime applicable to regular (subchapter C) corporations. Most of these entities now choose partnership taxation and file forms 1065. You will find, however, that accountants are all over the lot with these entities. Some have historically filed forms 1041, while others have filed 1065s and 1021s or no return at all. A copy of a form for a family compound trust with “unitized” beneficial interests is available for download at www.mckan.com. It is made available with the permission of its author, Gideon Rothschild, Esq.

G. C and S Corporations. In my experience, the corporate form is rarely used for family lands. For that reason, I will spend little time discussing it here. A regular “C” corporation would be a poor choice. The corporate form should be a good inside and outside liability insulator. But the two level tax regime will be murder -- particularly if the family decides to sell the property in the corporate form or liquidate it and suffer a huge capital gain tax liability at corporate rates, and have dividend treatment upon the distribution to the shareholders. An “S” corporation will solve the corporate tax problem. But it will create a whole host of other problems, primarily related to the restrictive rules for S corporation stock ownership and the possibility of an inadvertent termination of the S corporation status and the invocation of the C corporation double tax regime.

H. Tiered Structures. The LLC provides great creditor protection and discounting opportunities but is not good for generation-skipping because the LLC member interests gifted to the children will be included in their estates for estate tax purposes. And securing multiple annual exclusions by including spouses and grandchildren as donees of LLC member interests will require them to receive direct ownership of member interests -- something most clients will prefer to avoid. The charging order is good protection but a patient creditor can still extract a pound of flesh if and when LLC distributions are made. A generation-skipping trust with crummey powers can bring in the grandchildren and the spouses for annual exclusion purposes without giving them direct ownership interests. It will also allow for generation-skipping and eliminate the charging order problem. But no discounts will be available unless the

trust receives gifts of fractional interests, and the fractional interest discount will pale in comparison to those available for LLC member interests. Can the client get the best of both worlds by blending both strategies?

The answer: yes, provided that the nature and value of the property and the depths of the client's pockets justify it. One possible "tiered" structure: The LLC owns the real estate and leases it back to Mom and Pop on a triple-net lease basis. Junior, the LLC manager, uses the net rental income to pay the premiums on a LLC-owned second-to-die policy insuring Mom and Pop's joint lives which will produce a \$1 million endowment upon the second of their deaths. Mom and Pop gift the discounted member interests to a generation-skipping trust. This plan allows Mom and Pop to achieve sequential discounts because each of them will have contributed one-half fractional interests to the LLC, at an assumed 15% discounted value, in exchange for the member interests. Your client might like it, if he likes that sort of thing.

IV. Graphic Comparison of Alternatives.

If all of this is not enough, our website provides a some flowcharts illustrating the tiered structure described in the preceding paragraph, and a grid summarizing the most important strengths and weaknesses of each entity discussed in these materials.