# The Family Land Preservation Trust: Succession Planning for Heirloom Real Estate

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"Family Lands." The words evoke images of English nobility and the landed aristocracy; of country estates occupied by dukes and duchesses who inherited their titles and class standing as birthrights protected by the crown under the watchful eye of the House of Lords.

The concept is less familiar in this country. We rejected the British class system and its feudal underpinnings in the revolution. Ours is an egalitarian society in which everyone should have equal opportunity to prosper regardless of the social standing of their ancestors.

Our culture's ambivalent attitude towards inherited status and wealth is reflected in our laws. Congress enacted the federal gift, estate, and generation-skipping transfer tax systems with the express purpose of eroding and redistributing "dynastic" family wealth. Those families which have felt its bite will testify to the effectiveness of the transfer taxes in accomplishing those purposes.[1] Many will argue that this ethos rewards hard work and entrepreneurship, avoids creation of a leisure class, makes the most productive use of capital, keeps our economy competitive in the global marketplace, and sustains the quality and standard of living in this country.

Perhaps we all share this view to one degree or another. But that does not prevent one from acknowledging that the federal transfer tax system is a blunt instrument which sometimes produces unfair and arbitrary results. It is one thing to agree that it is bad public policy to allow the creation of a private welfare system through dynasty trusts holding fungible financial assets which allow generations of "trust babies" to clip coupons and lead unproductive lives. Unfortunately, however, certain non-financial "heirloom" assets get caught in the same vise. Included in this category are valuable (but illiquid) family lands.

Those families fortunate enough to own family lands do not all trace their lineage to a Carnegie or a Rockefeller. Many had enough good luck or foresight to acquire or inherit substantial lake or oceanfront properties, former family farms, and other rural lands before urban sprawl and improved transportation made them accessible and dramatically increased their "highest and best use" value.

The objectives of the senior generation in planning for the succession of these properties are not to allow their descendants to live indifferent lives of leisure and privilege. Rather, they are to inculcate a sense of family history and traditions — part of what makes sharing a surname special, and to preserve a gathering place at which geographically separated relatives can reunite to escape the pressures of their busy lives and maintain a sense of family. These are the fondest dreams of many senior generation family landowners.

## THE PRIMARY THREATS TO FAMILY LANDS

Creative solutions are at a premium in this area. There are surprisingly few resources available to aid the practitioner to plan successfully for the succession of family lands. Contrast this with the burgeoning body of law, literature, and practice aids on family business succession planning.

The attention given by professionals to family businesses is understandable. The estate planning and corporate bars in particular have a professional interest in tapping the small business sector of the economy which accounts for approximately one-half of the nation's Gross Domestic Product. Lawyers are well qualified to help entrepreneurial families find solutions to their transfer tax, business management, inheritance equalization (particularly relating to the "actives" and "inactives"), liquidity, and other problems. Crafting a successful business succession plan is both economically and personally rewarding for the professional and his or her clients who are counting on the family business to be a source of challenge, opportunity, and financial independence for future generations.

Thus, a well conceived business succession plan accommodates the entrepreneur's strong sense of stewardship. Senior generation family landowners often share this ethic. Indeed, for many of them stewardship becomes an obsession. Their sleep is haunted by visions of bulldozers, strip malls, or cookie cutter condominiums appearing on their sacred, irreplaceable ancestral lands. They dread seeing such a crass ending to a noble tradition which will deny future generations the privilege of experiencing an important part of the family legacy.

The crises that could produce such a catastrophe include not only confiscatory federal transfer taxes which will bludgeon the property every twenty five or thirty years as each generation passes. The family is wary of escalating carrying charges, most notably increasingly unmanageable local property taxes and property insurance premiums. They worry about the illiquidity of the family lands and their lack of income production, and the prospects of property mismanagement and divisive family politics resulting from a lack of shared vision among competing "stewards" and "liquidators" comprising various subbranches of the family in succeeding generations. They see divorces, bankruptcies, and lawsuits increasingly diverting and redistributing family wealth and assets throughout the United States.

There is rewarding work to be done here for those professionals who understand this psychology and can offer family landowners a means to achieve their complex, often idiosyncratic, and conflicting goals. The various permutations of the Family Land Preservation Trust (FLPT) provide a unique framework for this.

**THE FLPT CONCEPT**

The FLPT is specifically designed for the tax, economic, and administratively efficient multi-generational management, protection, and preservation of unique estate-quality lands and vacation compounds. It combines the creditor safety, tax benefits, and relatively simplified structure of an irrevocable common law living trust with many of the useful governance and management mechanisms of partnership and corporate structures. The FLPT will allow a family to retain and enjoy its family lands by:

1. *Arranging the transfer of the lands, plus a liquid endowment for their long-term maintenance and conservation*, in a manner which employs various discounting and other tax reduction strategies to deeply leverage the senior generation's unified credit and generation-skipping exemptions.

2. *Allowing descendants the coordinated use and enjoyment of the family lands* without subjecting the property to creditors, divorce settlements, or federal transfer taxes through the generations.

3. *Managing family conflict by providing an equitable, administratively manageable system for the centralized day-to-day management of the lands, while at the same time providing an overall system of representative democracy among broad branches of the family* to resolve issues of family policy such as the decision to sell, mortgage, or develop the lands.

4. *Providing individual descendants and subbranches of the family with limited liquidation rights*. This will allow future liquidators to cash in their beneficial interests in the FLPT on terms and conditions which are fair to both the liquidating heirs and subbranches and those stewards continuing their use and enjoyment of the property.

**WHEN TO USE THE FLPT**

As used in this article, the concepts of "family lands," "heirloom real estate," and "heritage properties" are not confined to ancestral estates. The FLPT is a useful planning tool for special properties acquired by the existing senior generation — even recently acquired — who envision and intend for the lands to be the focal point of a new family tradition.

The FLPT strategy is less concerned with a property's past than it is with the its future. At a minimum, to be a candidate for an FLPT, the lands should have some special recreational or aesthetic quality which the senior generation wishes to preserve for future generations. Typically, the property also has substantial enough economic value to require special planning and management to achieve the succession objectives.

Because much of the FLPT's unique features are tax driven, the senior generation landowner should also have some federal estate tax exposure. This problem may not be immediately apparent. Some individuals who have successfully used FLPTs have owned assets, including the family lands, with a combined value of approximately $1.2 million or even less. Their estate tax exposure under current law could be addressed through basic credit shelter planning involving property ownership rearrangements and by-pass trusts. But they were concerned that asset appreciation and income accumulation would push them over the $1.2 million threshold and that Congress might reduce the unified credit exemption amount below $600,000. They remember 1992's failed legislative initiative to reduce the exemption amount to $200,000. They have concerns about their descendants' estate tax exposure. Adding an outright, undivided interest in the family lands to their children's and grandchildren's wealth could create estate tax problems for them or exacerbate an already existing problem and require a forced sale of the property.

Finally, land-rich, but cash-poor landowners express concerns about the vulnerability of the family lands should one or both members of the senior generation require long-term health care. They are aware that the property will be subject to the spend-down requirements of the Medicaid law, or be sold to pay a Medicaid lien upon their deaths. They are interested in removing the property from the category of a "countable" resource in determining Medicaid eligibility. Transferring the family lands to the FLPT will trigger the six-year disqualification period during which the family lands will be considered a resource for means testing purposes. Using the FLPT strategy will help address the long-term health care threat as well.

**THE PLANNER AS FACILITATOR**

There can develop two factions within a generation owning or expecting to own a stake in the family lands. The "stewards" include those descendants and branches of the family who share the senior generation's traditionalist and conservation ethics. The "liquidators" are those who would rather not participate in this family tradition but would instead like to realize the property's substantial economic value.

The use of these titles is not intended to reflect a value judgment or have pejorative connotations. There are many reasons why a descendant or subbranch of the family might be a liquidator and not a steward. Greed and selfishness are not the only two possibilities.

This is not the 19th century when future generations stayed within close proximity to the family firm or farm. It was typical in those days for all or most of the family branches comprising the next generation to build homes on the family estate, or at least be in a position to regularly reunite there. The modern family exists in more of a diaspora. This is particularly true of those fortunate enough to own a heritage property. Branches of such families often include achievers who spread themselves throughout the nation and the world. Some of them may not have the ability or willingness regularly to use and enjoy family vacation property. Then again, others may see this dispersion as exactly the reason why preserving the traditional family gathering place is doubly important in the modern world.

Some senior generation stewards blindly assume that their children share their values and respect for family traditions. They have nothing to support this belief other than a vague notion that those sharing a common gene pool will also share a common stewardship ethic. This is always a dangerous assumption. Such clients must be encouraged to solicit the participation of the next generation in the development and implementation of the plan for the future of the family lands. Clients have been receptive to offers from the planner to facilitate family meetings at which all descendants can weigh in with their concerns, questions, and comments. Sometimes, these meetings produce a consensus not to plan for succession, but rather to plan for the development or liquidation of the property in an orderly manner that maximizes its economic value.

Some patriarchs or matriarchs respond to their indifferent or liquidator descendants by granting permanent conservation easements or donating the property to a conservation group to protect and preserve its aesthetic or conservation qualities.

In cases where the family decides as a group to proceed with the succession planning, the participation of the descendants — those who must live with the plan for the long term —improves the final product and makes the heirs more proprietary about it. It strengthens their commitment to stewardship and reduces the possibility that they will seek ways to undermine the structure once the senior generation is gone.

The planner should approach his or her preliminary role as facilitator and consensus builder the same way he or she would proceed as the prelude to family business succession planning. View it as an opportunity to introduce yourself to a new generation of movers and shakers who will have legal problems and needs of their own.

**COMPARISON OF THE FLPT WITH ALTERNATIVE STRUCTURES**

The FLPT concept has evolved over several years, enhanced periodically as new issues relating to management and control through the generations are identified. The author has considered other structures — including hybrid irrevocable trusts with external beneficial interests modeled after the Massachusetts "business trust" and Illinois "land trust," "quasi-business entities" such as S and C corporations, general and limited family partnerships, limited liability companies (LLCs), and tenancies in common subject to management agreements. In many cases, the FLPT, either standing alone or used in tandem with a family limited partnership, proves to be the preferred structure for several reasons.

**Trust as Management and Conservation Structure**

The common law trust has uniquely been adapted to manage and conserve non-business assets. In Anglo-American law the trust has evolved as a method for the management and conservation of property held primarily for investment or use by family members occupying generations below that of the grantor. Contrast this with the quasi-business entities which are designed to hold and operate active businesses and must be "retrofit" if applied out of context. This often results in uncertain tax treatment, unnatural structures, and unduly complex documentation and administration.

**Privacy and Ease of Administration**

The FLPT preserves family privacy and requires relatively little care and feeding. Unlike the quasi-business entities, the FLPT is a private arrangement which involves no public filings or annual filings or franchise fees. The trust document need not be recorded in most registries of deeds. In some states, for example, any conveyancing issues are addressed through the filing of a "certificate of trustee" evidencing the trustee's authority to hold and convey real estate. This preserves the family's privacy by avoiding publication of the dispositive plan.

**Creditor Protection**

Only the FLPT offers bullet-proof protection from creditors and divorces by avoiding external equity and ascertainable beneficial interests. At the core of the FLPT strategy is the immediate creation of separate creditor-safe discretionary generation-skipping subtrusts known as "family land trusts." The FLPT establishes one such trust for each branch of the family headed by one of the trust creator's living or deceased children. The family land trusts are each allotted an equal (or unequal, if desired) undivided share of both the family lands and any endowment fund.

Distribution of income and principal of each separate family land trust is committed to the discretion of a third party "disinterested trustee." No beneficiary is given any right to compel a distribution to him or her. Indeed, even the beneficiaries' common rights to use and enjoy the family lands are subject to the discretion of an "administrative trustee" who must coordinate and reconcile sometimes conflicting beneficiary requests to reserve the use of the property. (More on the role and purpose of the special administrative trustee is provided below.) Spendthrift provisions prohibit beneficiaries from encumbering their interests or assigning them in anticipation of receipt.

Because no beneficiary has an "ascertainable interest" in the form of a right to compel distributions or control any creditor sensitive powers, no beneficiary's creditor, or any dissident spouse or bankruptcy trustee for that matter, can stand in any better position relative to the trust property. The fully discretionary trust offers more liability protection than any of the quasi-business entity structures which involve the issuance of some external, transferable equity interests (stock, partnership, or membership interests) which are owned outright by family members and are subject to attachment.

Clients often specifically mention their fear of future divorces which might divert a portion of the property to a dissident former in-law. The separate family land trusts are designed to preclude this. The limited beneficial interests the FLPT gives to in-laws terminate upon their divorce or legal separation from their spouse who is a lineal descendant of the trust creator. Spouses of descendants are therefore only given a secondary, contingent beneficial interest in the family land trusts.

All of this creditor and divorce protection does not come at the cost of sacrificing the descendants' control or use and ownership of the family lands. The descendants are given non-tax or creditor sensitive interests and powers as "interested trustees," holders of special powers of appointment, and put options, and as eligible distributees of the trust assets. The FLPT's design gives family members as many of the benefits of property ownership as possible while still avoiding the most notable burdens: vulnerability to creditors, predatory spouses and, as discussed below in the analysis of the FLPT's tax treatment, a confiscatory federal transfer tax system.

**Separate Family Land Trusts**

The separate family land trusts are initially created on a per stirpital basis with respect to the children of the senior generation. This is where the per stirpital theme ends, however. Unlike most pure dynasty trusts designed to hold financial assets, the separate family land trusts do not later subdivide below the children's generation as each branch of the family proliferates. To do so would impose unmanageable recordkeeping and administrative burdens on the FLPT trustees.

This decision not to follow the per stirpital pattern as generations pass will probably create some disproportionality on issues of governance and critical decision making which are delegated to the board of interested trustees representing all branches of the family existing in the children's generation. (The role and powers of this board is discussed in more detail later in this article.) Such disproportionality would exist between those family branches which prove to be more or less prolific than others.

For example, if in 90 years the descendants of child X number 70 and the descendants of child Y number 40, the fact that the family land trusts established for X's and Y's descendants are each given one vote may be seen as unfair. This can be avoided by weighing each trust's vote based on the number of descendants who are beneficiaries of the trust at the time a vote is to be taken.

In our example above, if X and Y were the only children in whose names family land trusts were created, the interested trustee of X's trust would have a weighted vote of 63.63% out of a possible 100%. This is determined by dividing the number of X's descendants—70—by 110, the total number of descendants. Y's family land trust's weighted vote would be 36.36%. This gives the representative of X's descendants voting control on all interested trustee level decision making except on matters requiring a super majority vote in excess of 63.63%.

Most clients opt for a weighted vote system to address the disproportionality problem. Some even push for a system of true democracy (one man, one vote) in place of the system of representative democracy employed by the FLPT, but true democracy is unworkable. Imagine the trustee's difficulty in obtaining votes and proxies from 100 separate descendants living 100 years from now. Both spouses of the senior generation will be gone but the family will curse their memory.

**Management and Control**

The FLPT combines the traditional benefits of common law trusts with many of the management and governance features of quasi-business entities.

**The FLPT System for Centralized Management**

The FLPT achieves the same centralization of management as is available with any of the other alternative quasi-business entity structures. The administrative trustee is typically a responsible family member who serves a function analogous to that of a chief executive officer of a corporation, a general partner of a general or limited partnership, or a managing member of a LLC. The administrative trustee performs important day-to-day management and administrative functions which if performed by committee might produce inefficiency, deadlock, and acrimonious debate.

In addition to being responsible for coordinating the use and enjoyment of the family lands, this special trustee's powers include the ability to assess the separate family trusts for operating deficits that cannot be paid out of the endowment or its income. The FLPT operates in many respects similarly to a private time-sharing arrangement among family members with the administrative trustee functioning as property manager.

**The FLPT System for Representative Governance**

Like an executive officer or managing partner, the administrative trustee is accountable to a more representative body of decision makers who have power to hire and fire the administrative trustee. Issues of "strategic" (long-term) import, such as a decision to sell, develop, or distribute the family lands or approve substantial capital improvements, pursue property tax abatements, etc., are made or subject to approval by the majority vote of the board of interested Trustees.

One interested trustee of each separate family land trust is designated by certain of the trust's beneficiaries (specifically, the accountees of that trust[2]) to represent their separate branch of the family. They also have the power to adopt bylaws which may define issues such as suspension of beneficial rights for misconduct and granting leaves of absence for those family members who may temporarily be unable to exercise beneficiary rights and perform beneficiary obligations but who still wish to preserve the benefits of using the family lands for themselves or their future descendants.

The interested trustees will function as a *de facto* board of trustees, meeting periodically to discuss important issues. Unlike the directors of a corporation, however, they will not be constrained to meet annually if they prefer not to. Many families like the idea of bringing representatives of the separate branches together periodically — perhaps at the family lands — as a means of fostering a sense of common purpose and maintaining family communication and harmony.

These are the same benefits extolled by proponents of "family offices" and private foundations which are increasingly established by wealthy families to and provide a mechanism for "financial parenting" for future generations. It would not be unusual to find wealthy families employing one or more of these strategies and an FLPT. The annual family retreat or family meeting will be a forum for addressing all matters relating to the management and maintenance of all family enterprises and common endeavors.

This may be particularly important as generations pass and family members become geographically separated. The structure facilitates communication and conflict resolution before hard feelings can fester. By establishing a system of representative democracy the FLPT eliminates the possibility that an entire branch of the family will be disenfranchised.

**Discretionary Distributions**

A "disinterested trustee" is responsible for making any discretionary distributions of income and principal from each separate family land trust. The disinterested trustee may be an individual who has no beneficial interest in any of the family land trusts. The interested trustees appointing the disinterested trustee can define a short term of office and remove and replace an uncooperative or unresponsive disinterested trustee. This special disinterested trustee need not be appointed, however, until a tax- and creditor-sensitive discretion is to be exercised. This should in most cases be an unlikely occurrence for as long as the trust owns the ancestral lands.

The FLPT should be carefully crafted to create non-tax sensitive removal powers given the IRS's broad interpretation of Rev. Rul. 79-353,[3] despite the recent taxpayer victory in the Tax Court case of *Estate of Wall v. Commissioner*.[4] This keeps trusteeship in the family to the greatest extent possible. It preserves privacy and avoids the expense of corporate trusteeship.

**Liquidation and Transfer Rights**

Powers of appointment and put options give descendants limited liquidation and transfer rights. You may wonder how the FLPT can match the flexibility and protection offered to the family and its minority stakeholders through corporate and partnership buy-sell arrangements. They serve the salutary purpose of giving stakeholders a limited market in which to sell their interests and reshuffle them among family members, while still maintaining control in the immediate family. Buy-out provisions are structured to avoid imposing unmanageable financial burdens on those who continue in the enterprise. This is certainly an advantage of the quasi-business entities over the traditional common law trust.

The FLPT addresses the transferability limitations inherent in trusts by giving each beneficiary certain limited powers of appointment. Such powers allow descendants to adjust beneficial interests among their spouses and descendants. The FLPT handles traditional limitations on beneficiaries liquidation rights by engrafting onto the traditional trust structure certain "put" rights exercisable on two levels.

First, the FLPT allows each branch of the family to opt out of the arrangement by "putting" its family land trust's share of the property's value under terms and conditions which will not financially strain the other branches of the family continuing their FLPT participation, or force a distress sale of the property. This subtrust level structured put option is exercisable by the interested trustee of each separate family land trust.

Subjecting an interested trustee's proposed exercise of this power to the approval of a two-thirds majority of the subject family land trust's accountees protects against arbitrary action by the interested trustee. This leaves descendants in branches of the family who would not otherwise use the family lands property free to liquidate their interest in the trust on structured terms which are fair and reasonable to the stewards and liquidators alike. Such a limited liquidation right would not exist among co-tenants who in the absence of special provisions in a management agreement would be forced to resort to legal proceedings.

Second, in addition to the family land trust level put option, the FLPT gives individual beneficiaries similarly structured "personal" put rights which they can exercise for themselves and their minor children. This allows various individuals and sub-branches of the family below the children's generation to liquidate their interests in their family land trust if geographical separation, family economics, or other considerations preclude them personally from using and enjoying the family lands.

The ability of each family land trust to keep the family lands and endowment completely outside the federal transfer tax system for multiple generations is one of the most important FLPT features. The FLPT is carefully designed to avoid giving any beneficiary transfer tax sensitive powers or interests which could disturb the generation-skipping benefits. An unrestricted put right might be a transfer tax sensitive general power of appointment if the descendant holding that right had the ability to exercise it in favor of himself or herself, his or her creditors, estate, or the creditors of his or her estate.

**Lack of External Equity Interests**

There is another benefit to using a trust structure which does not require the issuance of external equity interests. The problems of transferability and vulnerability to creditors inheres in the issuance of external equity interests (stock, partnership, or membership interests) which are owned outright by family members. Shareholders or partners who hold stock or partnership interests in a family entity, for example, may make differing provisions in their estate plans for the distribution of those interests. Planners using quasi-business entities for family lands seek to solve the problems by interposing another entity, usually a discretionary generation-skipping trust, between the equity interests and the descendants. The tiered FLPT/FLP structure discussed below is one example of this structure.

The problems with external equity interests are illustrated by the fate that befell the Rockefeller clan and their beloved family compound at Pocantico Hills. Pocantico was the family's 3,600 acre retreat in suburban Westchester County. Family patriarch John D. Rockefeller, Jr., thought he did the right thing by placing it in a family corporation and distributing stock to second generation heirs John D. III, Nelson, Laurance, and David. During their lifetimes there was much discussion between the siblings concerning what to do with the property. Each had a different vision.

They never reconciled the conflict, and each sibling made different estate planning provisions for his stock. The whole mess was only recently resolved after years of expensive and bitter litigation involving descendants, surviving spouses, various charitable groups, and the IRS. All of this cost the family tremendous money and grief.

To be sure, Mr. Rockefeller could have (even may have) taken steps in buy-sell agreements and other corporate documents to impose transferability restrictions as a means of avoiding these problems. Share certificates can be legended to evidence the restrictions. But the family may still be required to resort to litigation to enforce them.

Avoiding an entity with external equity interests or creating a generation-skipping trust to hold the equity interests are sure-fire strategies which will eliminate the problem.

### Adaptable to Changing Circumstances

The FLPT is collapsible and offers almost unlimited flexibility to adapt to changed circumstances. The FLPT incorporates certain escape mechanisms (including various lifetime powers of appointment and discretion given to the disinterested trustee to distribute principal) that allow the family lands to be distributed to a new irrevocable trust arrangement the senior generation may create if tax law, time, family economics, or other events overtake the FLPT and render it obsolete.

Moreover, if a majority on the board of interested trustees directs that the family lands will be sold, the FLPT terminates and pours into the supplementary generation-skipping "dynasty" trust created in the FLPT document to hold each branch's share of the sale proceeds in creditor-safe generation-skipping solution to continue for the remainder of the applicable perpetuities period. Alternatively, the disinterested trustee of the family land trusts may make an outright distribution of the family lands or the proceeds of their sale among one or more of the descendants if in such trustee's judgment — presumably after consulting with the beneficiaries — such a distribution is more desirable than keeping the sale proceeds in generation-skipping solution.

## TAX EFFICIENCIES OF THE FLPT

In comparison to quasi-business entities such as corporations, partnerships, and limited liability companies, the Family Land Preservation Trust may be the most tax-efficient structure in which to receive and hold family lands and an endowment.

### Federal and State Income, Business, and Real Estate Transfer Tax Attributes

Unlike a C corporation, any income earned at the FLPT entity level can be passed through to the beneficiaries to achieve a single level of federal income taxation. This would apply to any net "operating income" from rental activities, timbering, etc., and capital gains should all or a part of the family land be sold in the future. The disinterested trustee may exercise its discretion to make distributions to beneficiaries in the year in which the income or gain was earned. All such net income and gain will be split among multiple trusts and beneficiaries under the distributable net income rules of Subchapter J of the Internal Revenue Code (IRC) in a flexible manner to achieve the family's optimal income tax planning.

The FLPT can also tax efficiently be funded, sustained, and dissolved. The donor's initial transfer of the property is treated as a gift for federal income tax purposes. There is no need to risk tripping on some technical requirement as you run the gauntlet of the provisions of the Internal Revenue Code dealing with tax-free incorporations or LLC and partnership formations. Funding the FLPT will not be a "sale or exchange" and therefore should not trigger any state or federal capital gains tax or other state business or income tax on any unrealized appreciation in the family lands or any securities used to fund the endowment. The FLPT succeeds to the donor's cost basis in the property.

Most states will exempt the transfer of the family lands from any state real estate transfer taxes because it is a gift, and transfer taxes are generally determined only as a percentage of the consideration received in any sale or exchange. Some states will assess real estate transfer taxes when real estate corporations or partnerships are capitalized. The assessment is based on the value of the stock or partnership interests received in exchange for the contributed real estate which is deemed to equal the net fair market value of the real estate. Unlike a C or S corporation, there is no entity level tax upon liquidation and distribution of the appreciated assets should the FLPT ever be dissolved.

### Federal Transfer Tax Attributes

The transfer tax efficiencies inherent in the FLPT strategy require the senior generation to irrevocably gift the family lands to the FLPT. The senior generation must understand this and be ready and able to accept all the consequences of making an irrevocable gift of the property. They must assume that they are forgoing their right to tap the equity in the property they might need in the future to sustain their lifestyle, finance long-term health care, or meet other financial emergencies. They should pay a fair rental value for any continued use and occupancy of the family lands.

While irrevocability will be an insuperable hurdle for some clients, creative structuring can overcome many misgivings. Both the requirement of the payment of fair rental value for continued occupancy and the senior generation's inability to access equity in the property can be finessed for married grantors by having each of them create separate FLPTs including separate "credit shelter style" trusts which give the other spouse a secondary life estate in the family lands and a beneficial interest as an eligible distributee of trust income and principal. This separate trust strategy and the reciprocal trust issues it implicates are discussed in Note 14, *infra*, and the accompanying text.

The requirement that the senior generation pay fair rental value can be viewed as a benefit and not a burden for those parents who have substantial liquid assets. Rental payments for the use of estate quality property can be substantial. Payment of rent for the use of property does not constitute a gift. It allows the shifting of more otherwise transfer taxable wealth to future generations without consuming any annual exclusion, unified credit, or generation-skipping transfer tax exemption.

The rent paid should at least be sufficient to cover all or, for seasonal properties rented only part of the year, most of the carrying charges during the period of continued occupancy. This will give any endowment the grantor initially establishes a "grace period" in which to grow before its net income or principal must be tapped to pay the carrying charges. If the rental income exceeds carrying charges, the trustee can add the excess to the endowment. Considering these potential benefits, it pays to work hard to convince proud, cash-rich clients that there is no shame in being a tenant.

**Managing the Federal Gift Tax Liability Upon Funding**

The FLPT is designed to minimize gift tax consequences on the front end. The gift tax value of the property to be contributed is almost always very substantial. It will include the value of the family lands and, in some cases, a substantial endowment to be invested by the administrative trustee (or, more likely, an investment professional such trustee retains) to produce an income stream which will make the FLPT economically self-sufficient. The aggregate value of the family lands and the endowment will often exceed the $1.2 million and $2.0 million combined unified credit and generation-skipping exemption amounts, respectively, available to married senior generation FLPT creators who both participate in the funding. Members of the senior generation will often be facing a substantial federal gift tax liability if they do nothing to address this problem. Many "land rich" but "cash poor" families will not have sufficient liquid assets to create the endowment, pay any gift tax, and still reserve sufficient liquidity for the senior generation's financial security.

The FLPT and the plan for its endowment can be designed to employ funding and discounting strategies to manage the gift tax consequences. These strategies include using qualified easements, exploiting the gift tax annual exclusion, and creating fractional interest, minority and marketability discounts.

**Using Qualified Conservation Easements**

Many family landowners feel a sense of stewardship toward not only past and future generations of their family, but, in many cases, their "extended family" of adjacent property owners and the community at large. There is often an unspoken pact among owners of adjacent family lands that they all hold their properties in a constructive trust for the benefit of each other and their respective families. To sell out to a developer is an unspeakable breach of that trust. They are interested in preserving the way of life which they and the other families owning similar properties on the same lake, for example, have long enjoyed. They desire to protect open space, scenic vistas, and habitat the lands may offer to wildlife, neighboring property owners, and members of the local community.

Clients expressing such strong conservationist ethics may grant conservation easements to charitable organizations such as local land trusts or state, regional, or national land conservation organizations. Assuming the conservation easement meets strict legal and tax requirements, it will restrict or even eliminate the development potential of the family lands and correspondingly reduce their fair market value for gift tax purposes.

The terms of the easement can be crafted to allow for limited development. The landowner can negotiate with the donee conservation group to reserve, for example, the right to subdivide and sell a limited number of building lots. This may substantially reduce the "highest and best use value" the property might otherwise have as a multi-unit condominium development. A limited conservation easement can allow the family the best of all worlds: protection of natural resources, reduction of the gift tax values, and preservation of some potential to "cash in" to some extent should property taxes, capital improvement plans, or other exigencies require a capital infusion to keep or improve the core family lands.

**The Crummey FLPT**

The most typical FLPT permutation is a *Crummey* trust designed to allow for multiple annual exclusions. Individual *Crummey* powerholders—those who are given limited rights to withdraw assets from the trust—will often include all of the donor's descendants living on the date of a trust contribution and their spouses. Each of them has a sufficiently substantial, vested beneficial interest in the FLPT to pass muster under the *Cristofani*[5] analysis. Many mature families have ten or more individuals among this class of beneficiaries.

To avoid generation-skipping and gift tax complications the FLPT limits each beneficiary's withdrawal right by the "five-or-five" lapse protection formula. This does not operate as a limiting factor in most cases because of the substantial value of the property contributed. The use of the lapse protection formula is necessary because the family land trusts are designed to skip generations. Giving a *Crummey* powerholder withdrawal rights in excess of the lapse protection amounts will shift "transferor" status from the senior generation property contributor to the descendant powerholder. Members of the senior generation will waste any generation-skipping exemption they allocate to the excess amount. The lapsing powerholder must allocate his or her own generation-skipping exemption to the excess amount to ensure zero inclusion ratio status for all FLPT property. Strictly limiting the withdrawal rights to the five-or-five formulation eliminates this complication.

For married grantors, the 5% prong of the formulation will allow a full $20,000 annual exclusion per donee where the property contributed and subject to withdrawal has a value of at least $400,000. A full $10,000 per donee annual exclusion is available for unmarried grantors where the property available for withdrawal is worth at least $200,000. Most FLPT contributions should exceed these threshold amounts. When they do not, the planner should consider the "hanging power" strategy which may be particularly appropriate for the serial fractional interest funding plan discussed below. Serial funding should rapidly create sufficient value to allow any hanging withdrawal rights to work themselves out before or shortly after the year in which the funding plan is completed. The *Crummey* powers should be sustained despite the illiquid nature of the family lands. The IRS has privately ruled that *Crummey* withdrawal powers may be satisfied by distributing a fractional interest in an illiquid asset.[6] The *Crummey* FLPT will specifically allow this.

This discussion assumes that the *Crummey* powers pertain to the entire amount of a contribution. The division of the contributed property among the separate share family land trusts will not occur until after the *Crummey* powers either lapse or are exercised and satisfied. This structure where the *Crummey* powers are "front-end loaded" is traditionally used for "single family pot" trusts.

By contrast, a "separate share" trust usually requires the trustee first to segregate the contributed property into the separate shares. *Crummey* powers are activated with respect to each separate trust. Only the beneficiaries of that trust are given *pro rata* withdrawal rights applicable to the trust's share of the overall contribution.

This separate share approach is often used in non-generation skipping trusts to allow the single or primary beneficiary of each separate trust to hold a lapsing *Crummey* power up to the full amount of the donor's or donors' annual exclusion amount. The taxable lapse problem is avoided without resort to the five or five solution because the beneficiary is given a deathtime power of appointment which prevents the gift from being complete for transfer tax purposes until the powerholder's death. At that time the property subject to the lapse power is included in the powerholder's estate regardless of the nature of the power of appointment as special or general. This "testamentary control" strategy has no utility for family land owners interested in generation-skipping; including any portion of the family lands in a beneficiary's estate will preclude generation-skipping.

Thus, the planner has available both the front-end loaded and separate share/non-testamentary control approaches in designing the FLPT *Crummey* powers. The choice between the two will depend on a number of factors. The benefit of the front-end structure is that it can maximize *Crummey* withdrawal rights where the eligible powerholders are not spread evenly across all branches of the family. The branch headed by child A might include child A's spouse and child A's five children. The branch headed by child B might include child B alone. Child C's branch has a spouse, four children, three spouses at that level, and two grandchildren.

In this example, C's branch has obviously been the most prolific. A's branch is less prolific, and B's includes only himself or herself. Depending upon the value of the property contributed, requiring a division of the contribution among the separate trusts prior to activating the *Crummey* powers will probably allow B's withdrawal rights to equal the entire amount of the donors' annual exclusion within the five percent portion of the lapse protection formula, but will probably relegate each powerholder in C's branch to $5,000 or less if each separate trust's equal share of the contribution is less than $5,000. Using the hanging power strategy will not allow full annual exclusions to be used for the beneficiaries of C's trust if their share of their trust's portion of the contribution is less than the annual exclusion amounts that might otherwise be available for them. This problem might not exist or might not be as acute under the front-end loaded structure which would spread *Crummey* withdrawal powers ratably across all descendants and their spouses. The choice between the two structures must be made with this in mind. The draftsperson should also consider the fractional interest discounting issues discussed below.

Some may question whether using the front-end loaded approach is an option for any trust other than a single family pot arrangement. The issue here relates to "naked" *Crummey* powers and the substantiality test applied in the *Cristofani* case. If, in the example above, C's descendants as a group are given withdrawal rights greater than the amount that is eventually allocated to their separate share trusts. Will the IRS disregard them because of their lack of any beneficial interests in the family land trusts to which two-thirds of the contribution will be allocated?

The answer might be "yes" if the family land trusts were true separate share trusts holding 100% interests in assets capable of separation from those held by all other trusts. The FLPT structure, however, does not build such strict firewalls between the separate family land trusts. Rather, the trusts are established more for recordkeeping purposes and to serve the maintenance, managerial, and governance objectives described above.

The nature of the beneficial interests of the beneficiaries of all family land trusts are such that they are entitled to use and enjoy the family lands in common with each other. The endowment is available to pay carrying charges and other costs and expenses on the family lands as a whole. The administrative trustee is not required to make physical segregation of the family lands or endowment. Rather, it has the authority to do so on its books and records only.

**Serial Funding With Fractional Interest Discounts**

Other discounts may be available to further reduce gift tax values. Arranging a transfer of the client's entire interest in the family lands requires the client to report a gift equal to the full fair market value of the property. Using serial transfers of undivided fractional interests should allow for some discounting to reflect the limited common law and statutory rights of tenants-in-common who co-own real estate. A serial funding plan could involve the annual transfer of one-half tenancy-in-common interests over a two year period, one-fifth interests over a five year period, or any other variation on this theme.

The IRS has recently privately ruled that the fractional interest discount for undivided interests in real estate is limited to the costs of partitioning the property.[7] The Tax Court, however, has been more liberal. In the recent case of *LeFrak v. Commissioner*,[8] the Tax Court allowed expert opinion on the minority and marketability discounts for undivided gifts in apartment buildings and other income producing real estate. The court finally approved a combined discount of 30%.

*LeFrak* may be of limited precedential value for gifts of undivided interests in family lands held primarily or exclusively for personal use and not income production. Establishing the discount for such real estate is, unfortunately, more art than science. Professional appraisers with whom the author has worked feel that conservative fractional interest discounts in the 15% to 20% range are nonetheless defensible. This is the appraiser's call, not the planner's.

While it will increase the cost, clients must be convinced that a full professional appraisal is absolutely necessary to avoid a valuation controversy with the IRS, or strengthen the client's hand if values are questioned. Full blown appraisals of estate-quality property can run from $1,000 to $15,000 or more depending upon the size and nature of the lands, the number and nature of the structures on the lands, the existence of conservation easements or other restrictions, etc. The appraiser will likely charge a premium for assessing any fractional interest or other discounts. The family should also strike a deal with the appraiser for updates to support future serial fractional interest gifts, and any current and future fair rental value appraisals if the senior generation contemplates a gift-leaseback.

This discussion of fractional interest discounts and the serial funding plan assumes that the FLPT uses front-end loaded *Crummey* powers. An FLPT using the separate share approach will require the family lands to be fractionalized among the separate family land trusts in the contributor's deed accomplishing the funding. A deed to such an FLPT creating separate family land trusts for each of the grantor's five children would reflect equal one-fifth tenancy-in-common interests being transferred to each such trust. The gift of each interest would qualify for the fractional interest discount. This telescopes all discounts into one year of funding and avoids the necessity of spreading funding over several years.

The approach has the virtue of avoiding the expense and inconvenience of multiple deeds and appraisal updates. It also eliminates the risk that one or both senior generation grantors might die before the funding is complete. The planner must consider these advantages against the multiple annual exclusion related disadvantages of the separate share approach. This further compounds the difficulty in choosing between the two alternatives.

Finally, FLPT design features might be considered in the appraisal process. The facts of *LeFrak* and its progeny involve outright fractional interest gifts to individuals or to trusts which do not impose substantial restrictions on the beneficiaries' use and enjoyment of the trust property. By contrast, the FLPT is an unusual trust arrangement which gives beneficiaries extraordinarily limited beneficial rights and powers. These include the limited liquidation rights provided through the put options, and restrictions on the use and enjoyment of the family lands such as the administrative trustee's ability to regulate and coordinate the use and enjoyment, charge rent, require the payment of assessments, etc. The exercise of a put option might be suspended for a period and will usually require the payment of a purchase price equal to some percentage (usually 75%) of the putting trust's or accountee's interest in the family lands or the subject family land trust. All of these features may justify further discounts over and above the baseline percentage the analysis in *LeFrak* line of cases would allow. Indeed, because the FLPT beneficiaries have rights and powers entirely different than the rights and interests of a co-owner of real estate, an appraiser may determine that the analysis and methodology applicable in *LeFrak* and its progeny are entirely inapposite. The appraiser may resort to an analysis similar to that used in determining marketability and minority interest discounts for equity interests in family corporations and partnerships. (See a discussion of these methods of analysis elsewhere in this issue.)

**The FLP Overlay**

The stand-alone *Crummey* FLPT employing the serial fractional interest funding plan affords some leveraging and discounting opportunities. Reading this article, one may get the feeling that this strategy and the use of a family limited partnership to own family lands are mutually exclusive. In fact they are not. For those clients focusing on the extraordinary discounting opportunities FLPs offer, the planner can offer a tiered FLP/FLPT structure.

Members of the senior generation will transfer the family lands to the FLP in exchange for general and limited partner interests. They may retain the general partner interests and gift the limited partner interests to the FLPT. The FLPT *Crummey* powers will preserve annual exclusions to the same extent as they would if the family lands themselves were contributed to the trust. The FLPT will provide a generation-skipping ownership structure for the limited partner interests. This is discussed in more detail below. Maintenance and property management will be provided by the general partners at the partnership level. The senior generation family members may remain general partners for their lives and thereby retain control of the partnership property, including management of any endowment, and pay themselves a management fee. Note, however, that this does not eliminate the need to pay fair rental value to avoid estate taxability of the family lands in the senior generation under IRC §§2036 and 2038. In fact, because the partnership, and not the FLPT, owns the property, the senior generation does not have the opportunity to use two credit shelter style FLPT's as a means of eliminating the fair rental value requirement. The partnership can be dissolved at any time to take advantage of the unique governance and management features of the FLPT. While this tiered arrangement might be somewhat cumbersome and more complex, it can be employed with dramatic success under the right circumstances.[9]

**The Articulated QPRT**

The conservation easement, fractional interest, and FLP overlay discounting strategies can be used in conjunction with a generation-skipping FLPT with or without *Crummey* powers. An FLPT created on the expiration of a qualified personal residence trust (QPRT) term can sometimes be used as a gift tax management alternative to *Crummey* powers. The author refers to this two part trust as the "articulated QPRT."[10]

Using the QPRT on the front end can provide two benefits: (i) if the trust creator survives the QPRT term, the FLPT is funded at a federal gift tax value equal to the total value of the property, minus the actuarial value of the income and reversionary interests the donor retains in the QPRT; and (ii) members of the senior generation are entitled to the rent-free use and enjoyment of the property for the chosen QPRT term without causing any estate tax complications if they survive that term.

Despite these apparent advantages, the *Crummey* FLPT is superior to the articulated QPRT for family heritage properties. The discounting and *Crummey* strategies will in many cases require the consumption of a comparable amount of the senior generation's unified credit as would a successful QPRT. In fact, the serial gifting/fractional interest and FLP/FLPT tiered structure discounting strategies may under any given facts allow even greater savings than those offered by the QPRT. Using the *Crummey* FLPT involves no risk of a premature death and a loss of leveraging benefits. Most families with appreciating family lands want the guarantee that their chosen strategy will produce the desired value shifting, value-freezing, and leveraging benefits critical to the success of the succession plan.

QPRTs may be inappropriate for estate-quality properties for several other reasons. First, the regulations under IRC § 2702 include a vague and limited definition of a qualified personal residence.[11] This makes it perilous to use a QPRT for many family lands unless the client is willing and able to spend the time and money required to obtain a private letter ruling. The existence of guest houses, outbuildings, and substantial acreage may disqualify the property even if a portion of it is used as a residence.[12] QPRTs are most appropriate for more generic, fungible vacation property — such as a snowbird's Florida condominium — where the primary goals are retention of personal use and perhaps some possible transfer tax savings. In such cases, preserving a unique asset for future generations is not usually an objective or is at best a secondary goal. The trust creator is more willing to gamble on the transfer tax benefits.

Second, unlike the *Crummey* FLPT, the articulated QPRT does not allow leveraging of the donors' generation-skipping exemptions. The current generation-skipping regulations preclude allocation of generation-skipping exemption against transferred property until the closure of the "estate tax inclusion period."[13] For QPRTs this period does not close until the grantor survives the QPRT term. The articulated QPRT strategy would require a generation-skipping transfer tax exemption allocation at that time before the family lands are poured into the FLPT. The allocation must be made dollar for dollar against the appreciated fair market value of the family lands on the date of the expiration of the QPRT term. The opportunity cost can be substantial if the QPRT extends for several years and the property rapidly appreciates after the date of funding.

Finally, the QPRT regulations prevent the establishment of anything other than a modest short-term endowment to defray imminently payable carrying charges.[14] The grantor must defer creating the long-term endowment until the QPRT term ends.

**Joint Versus Separate FLPTs for Married Couples**

One variation of the FLPT is a joint trust to be created and funded by a husband and wife. It assumes that they co-own the family lands and that each of them will transfer his or her fractional interest to the same trust. This joint FLPT structure, however, may not be necessary or even desirable in any given case. Each senior generation spouse might prefer to create his or her own separate FLPT. The separate FLPT structure may offer two advantages.

First, it can eliminate or mitigate the requirement that members of the senior generation must pay fair rental value for their continued occupancy after they transfer the family lands to the FLPT. As illustrated above, paying fair rental value for continued occupancy can produce certain transfer tax benefits. But it can also impose current or future financial burdens on a cash poor or financially insecure senior generation.

Having two FLPTs avoids the problem because like most credit shelter trusts created for a surviving spouse, each spouse's separate FLPT gives the other the right to rent-free use and occupancy of the fractional interests in the family lands held by the grantor spouse's FLPT. These spousal life estates ensure continued occupancy for as long as both spouses are alive. After the first death the surviving spouse need only pay one-half fair rental value to his or her own FLPT.

The separate "credit shelter style" FLPT structure avoids the application of the reciprocal trust doctrine by creating different spousal beneficial rights and interests in each trust. Those differences should be sufficiently substantial to avoid a finding that the trusts are interrelated under the reciprocity analysis of *Estate of Grace*[15] and its progeny. The two trusts are designed to merge as a single continuing FLPT at the second death.

The second advantage of separate FLPTs is each spouse's eligibility to receive principal distributions from the other spouse's FLPT in the discretion of a "disinterested" trustee. The non-grantor spouse may possess both lifetime and testamentary special powers of appointment over principal, authorizing him or her to appoint the family lands or the proceeds of their sale to the other spouse. This possibility of direct access to the FLPT principal —including liquid portions of any endowment — is especially appealing to clients intimidated by the FLPT's irrevocability.

Of course, any such outright distributions will remove the distributed property from the transfer tax and creditor protected solution of the FLPT. Distributions to the senior generation might be particularly transfer tax inefficient because they will waste any unified credit and generation-skipping exemption consumed when the FLPT was funded. For this reason, such distributions can take the form of loans which will not augment the parents' estate tax base. The important point is that the FLPT offers sufficient flexibility to do that which is in the family's best interests depending on tax and non-tax considerations at the time that an important decision regarding trust distributions must be made.

**Endowing the FLPT**

Before deciding how to build the endowment, the client must first determine a target endowment funding level. The creation of an adequate endowment is often critical to the success of the FLPT. Escalating carrying charges — most notably property taxes — can force cash poor descendants to bail out of the FLPT early. This is particularly true of those beneficiaries who cannot be expected to have deep pockets of their own from which to pay assessments. Many senior generation landowners will not want to burden their descendants with this obligation anyway.

The factors to be considered in determining how much endowment is enough will vary from case to case. The most critical factor is how much "help" the senior generation wants to give their descendants. If the objective is to make the trust self-sustaining for the indefinite future, the senior generation should first establish long-term budgets for the property. A 50-year operating budget would include ordinary repairs and maintenance adjusted for inflation, and insurance premiums and property taxes which would flight upward based on historical and likely future patterns. This will require some crystal ball gazing. The family would be well advised to enlist the help of real estate consultants and land use planners. These professionals will aid in developing a long term land use plan which might, for example, earmark specific portions of the property for conservation easements or gifts, and identify subdividable "insurance lots" to be "land banked" for future sales should a need for liquidity arise. The family should also consider some reduction of endowment principal to pay for foreseeable capital improvements as shown in a long-term capital improvements budget which the family should also prepare.

After completion of the budgeting and long term land use planning exercise, the senior generation can benefit from the assistance of investment professionals who can help determine how much principal will be required to produce income to meet the budgeted requirements. Professionals can help develop a long-term investment program for the endowment which would presumably include some asset allocation between equity and fixed income securities. Building equity growth into the endowment portfolio will be particularly important given the long-term planning horizon.

The client might decide to plan for the endowment's income to satisfy some portion of the annual operating deficit, leaving the trust beneficiaries to satisfy the balance through the assessment procedure. It is helpful to solicit the input of the descendants in making these decisions. In any event, regardless of how the family chooses to resolve this issue, devising some carefully considered plan for the establishment and investment of the endowment is critical to the FLPT's long term success. Neglecting this part of the process may disable the descendants from continuing the ownership of the family lands for as long a period as the senior generation envisions.

The income from the endowment will be used primarily to defray annual operating expenses. The principal would be tapped only to fund capital improvements which cannot be financed from other sources, such as loans against the equity in the family lands. If these sources are insufficient to sustain the family lands, the administrative trustee may assess each separate family land trust for its share of an operating deficit or capital improvements budget. The FLPT gives the administrative trustee the discretion to make disproportionate assessments based on his or her judgment whether one or more branches of the family disproportionately benefited from the use and enjoyment of the family lands during an operating assessment period, or will disproportionately benefit from a proposed capital improvement.

Contributions made by beneficiaries to fund operating assessments should not create any retained interest problems for the contributors under IRC §§ 2036 or 2038, or disturb the generation-skipping transfer tax inclusion ratios of each separate family land trust's share of the FLPT property, because such payments only maintain, and do not enhance, the value of the trust property. Payment of these expenses are generally the obligations of life tenants under common law and statutory principal and income allocation rules.

The capital improvements assessments will, however, stand on a different footing. Their payment will enhance the value of the principal and will therefore be deemed a potentially transfer taxable "gift" to a trust in which the contributing beneficiary holds interests and powers subject to IRC §§ 2036 and 2038. This will disturb the 100% generation-skipping transfer tax-exempt character of the property and create fantastic administrative problems for the trustees. This is why precatory language in the FLPT will encourage the administrative trustee to resort to capital improvements assessments only if other sources of financing are unavailable. Alternative sources would include first the excess income and principal of the endowment, then any loans from third party lenders or beneficiaries and even the proceeds of any sales of any land banked "insurance lots". The administrative trustee will have more flexibility to negotiate payment terms for beneficiary loans as opposed to loans from third party lenders, particularly banks. A beneficiary loan could be structured to provide for a balloon repayment upon the death of the beneficiary/lender from the proceeds of any insurance owned by an "endowment builder" irrevocable life insurance trust (see below) owning a policy on the beneficiary's life.

## Leveraged Endowment Building Strategies: Charitable and Life Insurance Trust Overlays

### The Charitable Lead Trust

Supplementary leveraging strategies are available to help build the endowment. These include a charitable lead trust (CLT) or trusts funded with appreciated securities. The CLT is particularly useful if the only liquid assets available to seed the endowment are appreciated publicly held securities which if sold outside the CLT would produce substantial capital gains taxes. The CLT pours into the FLPT upon the expiration of the charity's annuity or unitrust term and produces the unified credit and generation-skipping exemption leveraging opportunities inherent in CLTs.

The CLT can be used in tandem with a plan which involves a more modest initial cash seed to fund the endowment so that the FLPT is economically self-sustaining during the term of the charity's lead interest. Net rental income from the grantor's tenancy may also help defray or even eliminate any operating deficits during this initial period.

**Irrevocable Life Insurance Trusts**

Insurance can also play an important role in leveraged endowment building. An irrevocable life insurance trust (an "endowment builder ILIT") established to own a second-to-die life insurance policy on the joint lives of married FLPT creators is perhaps the most transfer tax efficient means of building a substantial permanent cash endowment. Advantages, add-ons and caveats:

- The ILIT strategy optimally allows the family to convert their 45 cent premium dollars into 100 cent death benefit dollars which will explode in value on the second death by some multiple of the cumulative premium outlay. The unified credit and generation-skipping exemption leveraging opportunities offered by ILITs have made them the darlings of the estate planner's nursery for decades.
- The client may own large blocks of appreciated securities which must be liquidated to meet premium payment obligations. Such clients may employ a charitable remainder trust in tandem with an endowment builder ILIT as a tax favored means of producing the cash flow sufficient to service the premium obligations, while still managing the capital gains tax consequences of selling the securities.
- The endowment builder ILIT may be designed as a *Crummey* trust. If it is, the ILIT's funding must be coordinated with the annual exclusion funding of the FLPT. In the first few years, the FLPT will likely consume all available annual exclusions so that none of the ILIT cash infusions paid in those years will qualify for the annual exclusion. This problem should only last until any FLPT serial funding plan is completed. The conclusion of the plan will liberate annual exclusions to protect ILIT contributions. The senior generation should be careful annually to allocate generation-skipping transfer tax exemption dollar for dollar to any cash or other property contributed to the ILIT to achieve a zero inclusion ratio for the insurance proceeds ultimately poured into the FLPT.
- The ILIT proceeds are also available to equalize the inheritances of the liquidators in those branches of the family who choose from the outset not to participate in the FLPT. All of the strategies employed by family business and succession planners to equalize the inheritances of the "actives" and "inactives" can be applied in the FLPT context to equalize liquidators and stewards.
- A portion of the endowment builder ILIT fund can be earmarked for ancillary purposes related to the family lands as well as traditional ILIT purposes such as providing estate liquidity. For example, a client might earmark $100,000 of the endowment builder ILIT's life insurance proceeds to establish a permanent "scholarship fund." This fund would be held in trust with the income (and principal, if necessary) used to finance travel for needy, geographically remote descendants and their families who could not otherwise afford to fly to the family lands for vacations, reunions, or other traditional family functions.
- Endowment building can be an ongoing family affair. Children and further descendants should be encouraged to shoulder a portion of the economic burden of stewardship by creating their own endowment builder ILITs while they are still young and premium outlays are manageable. This can provide a transfer-tax efficient infusion of fresh endowment capital every twenty to thirty years. Each endowment builder ILIT may be applied either to the general endowment, or to a sub-endowment created to defray any assessments against the insured descendant's branch or sub-branch of the family.

**The FLPT is Singularly Suited for Generation-Skipping**

Of all the competing structures for the ownership and management of family lands, the true common law trust—i.e., a trust without external beneficial interests—alone offers the opportunity to skip generations.

To reiterate an earlier discussion, using a quasi-business entity alone to hold family lands requires the descendants to receive valuable equity interests such as stock or partnership certificates. The value of these external interests held by the future generations will not only be reachable by their creditors and hostile spouses, but will also be subject to estate taxation upon the descendants' deaths. Estate planners have used two techniques to try to solve the problems. One strategy seeks to reduce the value of the descendants' stock or partnership interests by imposing transferability restrictions and using other discounting methodologies. Discounting can mitigate the estate and creditor protection problems of the owners of the discounted interests, but they cannot solve them completely. Planners solve the generation-skipping problem by interposing a generation-skipping trust between the external equity interests and those family members who would otherwise be partners or shareholders. One variant of this "tiered" structure, the FLPT with the FLP overlay, is discussed in more detail above. Clients interested in maximizing their discounting and leveraging may be well-served by this structure, provided they can stomach the transactional complexity: public filings and annual fees, separate sets of books, and multiple records and tax returns.

The beneficiaries of a tiered or stand-alone FLPT (or any other true common law trust for that matter) have no external interest in the family lands left exposed to estate taxation or attachment. The FLPT guarantees that members of future generations hold non-ascertainable "beneficial interests," the use and enjoyment of which are subject to the disinterested trustee's discretion. Those interests have no value to tax upon the beneficiaries' deaths. By placing the family lands in the FLPT and allocating a portion their generation-skipping transfer tax exemptions to the transfer, the senior generation can protect the heritage property from generation-skipping transfer taxes which would otherwise be payable upon termination of the trust or any other occasion for distribution of FLPT property to the beneficiaries.

The FLPT thus provides a completely transfer tax-safe environment for property ownership available for as long as it continues. It avoids having estate taxes applied to the family lands as generations pass every twenty-five or thirty years — a levy which prevents many families from preserving their lands and realizing their full value through an orderly liquidation, the timing of which they, and not some outside agent or force, choose and control. A family may mourn the forced sale of heritage property as they would the premature death of a family member. The memories of the former family sanctuary where Johnny caught his first fish and learned to swim and sail will cause many a tear to fall on the family photo album.

**Disadvantages of the FLPT Relative to the Alternative Structures**

There are three disadvantages of using the FLPT for family lands. First, the rule against perpetuities will probably limit the FLPT's duration to somewhere between seventy and one hundred years in a common law state. Second, despite the positive comments above on the federal income tax treatment of the funding and dissolution of the FLPT, the currently confiscatory federal income tax rates applicable to trusts are generally less favorable than then the corresponding systems for taxing the alternative qualified business entities, with the exception of the C corporation. Third, quasi-business entity structures, particularly family limited partnerships, arguably offer greater gift tax value discounting opportunities. Each of these objections can be addressed by the creative FLPT architect.

**The Rule Against Perpetuities**

Many clients do not view the perpetuities limitation as a particular problem. Nonetheless, families should be aware that it has peculiar application to trusts and not to the alternative structures. Trusts, however, are the only structures available to optimize generation-skipping opportunities. The planner should ask clients, "would you rather have your ancestral lands repeatedly subject to estate taxes, possibly as high as 55%, every thirty years or so as a generation passes, or limit the duration of the arrangement to the perpetuities period?" The answer is usually obvious.

There may even be some legal means to avoid the perpetuities problem if any given family is interested in creating a longer term or truly perpetual trust. The FLPT might define measuring lives by reference to a particularly prolific and well known family such as the numerous living descendants of Brigham Young, a famous polygamist. The Mormon community may make genealogical services available for tracing members of the broad class of descendants who will serve as the measuring lives. A FLPT using this strategy can be expected to last for longer than one hundred years. It may be possible to use a governing law provision incorporating the laws of a state, such as South Dakota, Idaho, or Wisconsin, which has no perpetuities limitation. This might succeed if the FLPT is drafted to have some minimal connection to the governing law state such as a domiciliary non-fiduciary special trustee or trust protector serving on an active or standby basis. The intrepid planner may even resort to such exotic strategies as the "Delaware tax trap".

Even if the perpetuities limitation requires termination of the trust at some point, the remainder beneficiaries may decide to "recycle" the property into a multi-generational FLPT or FLPT's of their own creation. Presumably at that time there will be multiple remaindermen such that no single beneficiary receiving a fractional interest in the property will suffer unmanageable transfer tax consequences when funding a new trust. For example, if in one-hundred years the family lands held in a FLPT have a value of $10 million, and there are seventy FLPT beneficiaries, each of whom receive an undivided interest in the property upon the FLPT's termination, each 1/70th share of the property is worth less than $150,000 — a value which should not confront any one of the remainder persons with an overwhelming transfer tax challenge.

### Income Tax Rates

The trust's deductible expenses will include property taxes, interest on any loans made to the trust, expenses for maintenance and upkeep, and any management or other fees paid to the administrative trustee and any professional he or she retains. These expenses may be substantial enough to "zero out" any rental or investment income the administrative trustee receives. If they are not, the problem with trust income tax rates can be addressed as described above — the trustee has the flexibility to make a distribution in any year resulting in reporting of income or capital gain by the beneficiaries. This, however, may cause unnecessary leakage of GSTT exempt assets. It can also be inconsistent with the family's desire to reinvest after-tax income to build the endowment.

As an alternative to zeroing out trust distributable net income through trust deductions and distributions during the FLPT grantor's or grantors' lives, the planner might employ the defective grantor trust gambit. An FLPT without *Crummey* powers can be made defective with respect to its grantor or grantors. One innocuous provision in the FLPT which should achieve this result is giving the grantor or grantors the power, acting in a non-fiduciary capacity, to substitute trust assets. This power should render the trust completely defective as to income and principal and avoid the trust tax rates (and all the rules of Subchapter J of the IRC, for that matter). All FLPT income tax attributes will be reportable on the tax return of the grantor or grantors. Paying the tax on income and capital gains they never receive allows the senior generation grantors effectively to make additional federal gift tax-free transfers to the trust, provided that the IRS does not successfully assert that paying a tax on income received by another is itself a gift taxable transfer. A provision of the trust negating any state law right of reimbursement the grantors may have against the FLPT should eliminate this possibility.

Be aware: the IRS has privately ruled that any irrevocable trust with multiple *Crummey* powers is also subject to the grantor trust rules IRC §678 applied at the level of the withdrawal powerholders. Each powerholder allowing his or her withdrawal rights to lapse may be treated for federal income tax purposes as having made a contribution to the trust.

The five-or-five lapse protection formula is a gift tax concept; it does not apply in the federal income tax context. If the lapsing powerholder also has underlying powers and interests in the continuing trust which would cause grantor trust characterization under IRC §§ 671-678, he or she is technically treated as a grantor with respect to that portion of the trust property to which the lapsed withdrawal rights pertain.

The typical FLPT structure gives lapsing *Crummey* powerholders multiple defective grantor trust powers and interests. They include the right to receive distributions of trust income without the consent of an adverse party. Each such powerholder will therefore technically be accountable for a share of the FLPT's income. If, however, the original donor has retained grantor trust powers or interests in the trust, grantor trust status as to the donor "trumps" §678 grantor trust status as to the beneficiaries. Therefore, the income tax compliance problem commences only when the FLPT grantor dies. It will expire with the deaths of the *Crummey* powerholders.

This tax compliance conundrum is probably more academic than practical. It exists with all multiple beneficiary *Crummey* trusts but is widely ignored by both the IRS and fiduciary income tax return preparers. To comply would require bookkeeping and audit difficulties that no return preparer or IRS agent seems yet willing to confront. This could change, however, now that there is a large differential between the rates applicable to trust and individual income, and a successful fiduciary income tax audit could bring in substantial tax dollars. In any event, the problem should be mentioned to the clients to cover the odd chance that the trust's returns are ever audited.

### Discounting Gift Tax Values

Aggressive appraisers assign combined marketability and minority discounts for gifted limited partnership interests that can range from 30% to 60% of the donee limited partner's percentage interest of the value of the underlying partnership assets. These discounts can far exceed the conservative 15% to 20% discounts commonly assigned to fractional interests in commonly owned real estate transferred to a stand-alone FLPT, particularly when the value of that real estate is high. Moreover, the gift of the endowment to the FLPT cannot be discounted as it could if it were stuffed into a FLP subject to a partnership agreement which imposes significant restrictions on control, transferability, and liquidation rights.

However, as is described above, gifting a lump sum of cash or a block of marketable securities directly to a stand-alone FLPT is the least transfer-tax-efficient method for building the endowment. Using the endowment builder ILIT and the CLT as leveraged endowment building strategies can offer wealth-shifting benefits rivaling (even surpassing) the FLP discounts. The FLPT architect can define and limit the rights of the beneficiaries of the separate family land trusts in a manner which may justify discounts greater than that normally allowed for fractional interests in real estate.

Such strategies should bring discounts for transfers of family lands to stand-alone FLPTs more in line with those which would be available if the FLP structure were used. For those clients obsessed with the discounting opportunities offered by the FLP there is always the more complex FLP/FLPT tiered structure. For many clients, however, the overwhelming advantages of the stand-alone *Crummey* FLPT outweigh any modest leveraging and discounting benefits which may in any given case be offered by any of the competing structures.

**NOTES**

[1]In a 1986 article surveying the attitudes of several American multimillionaires on inherited wealth, *Fortune* magazine reported the following:

> Once formed, a chain of inherited wealth is rarely broken — until the money runs out. It has pretty much run out for some of the great names of U.S. business: the Dodges, Reynolds, and Vanderbilts. The sons of Texas oil tycoon H.L. Hunt, whose fortune was once estimated at $8 billion, have just filed for bankruptcy protection for the family's corporate jewel, Placid Oil Co.

"Should You Leave It All to the Children?," *Fortune*, September 29, 1986, at 18.

[2]As used in the FLPT, "accountees" are those persons entitled to receive accountings of the trustee's administration. They are defined as all adult lineal descendants of the FLPT creator or creators and a parent or legal guardian of any lineal descendant who is a minor or is legally incapacitated. Spouses of lineal descendants are excluded as accountees except when acting in a representative capacity as the parent or legal guardian of a minor or disabled descendant.

[3]Rev. Rul. 79-353, 1979-2 C.B. 325.

[4]*Estate of Wall v. Commissioner*, 101 T.C. 300 (1993).

[5]*Estate of Cristofani v. Commissioner*, 97 T.C. 74 (1991).

[6]See generally TAM 8445004 (involving gifts of partnership interests to a *Crummey* trust, and discussion of distribution of the interests in kind in lieu of liquid assets); PLR's 8006109, 8021058 and 8134135 (dealing with delivering insurance policies, or fractional interests therein, to exercising *Crummey* powerholders, in lieu of cash). *See also* TAM 8445004 (*Crummey* powers upheld where trust contribution is illiquid, but trust instrument permits trustee's sale, mortgage or other distribution to satisfy a demand right in cash). The cautious practitioner will authorize trustee borrowing against the real estate in satisfaction of any exercised withdrawal right.

[7]TAM 9336002. For an excellent criticism of this ruling and the IRS's position in general, *see* Polacek and Lehn, *Tax Court Allows Sizeable Fractional Interest Discounts*, 133 Trust & Estates 29, 39-40 (1994).

[8]*LeFrak v. Commissioner*, T.C. Memo 1993-526 (1993).

[9]Immediately before this article went to press, the IRS issued the partnership anti-abuse regulations under IRC §701. The predecessor proposed regulations were roundly criticized by practitioners as being overbroad, vague, and capable of being applied to FLP's to limit or eliminate marketability and minority discounts. IRS personnel informally stated that the regulation was not targeting FLPs used as wealth succession strategies. Rather, they indicated that the regulation was aimed at large partnerships, including publically traded partnerships, which the Service believed were being used to produce artificial income tax benefits which it deemed to be "abusive." These assurances gave family wealth succession planners some comfort.

However, examples included in the regulations as finally issued should rekindle practitioners' concerns. Examples 5 and 6 are particularly troublesome for situations in which (i) the asset transferred to the FLP is non-business "use" property such as a personal residence, and (ii) the transaction involves the creation of the family partnership immediately before gifts of partnership interests. One practitioner has expressed concern that the existence of these two facts would allow the IRS to invoke the remedial provisions of the regulation, resulting in a denial of any marketability or minority discount. Lemons, "Family Wealth Planning Aspects of The Partnership Anti-abuse Regulations," 66 *Tax Notes* 439, 440 (January 16, 1995). ***Editor's Note: Examples 5 and 6 were withdrawn on January 23,1995 (Announcement 95-8) and the IRS has indicated that the Regulations are not intended to apply to the transfer tax system.***

It is unclear whether the senior generation's payment of rent to the FLP would create economic activity sufficient remove the tiered FLP's/FLPT structure from the reach of this regulation. In any event, practitioners using FLP's to hold personal residences should perhaps move slowly until further guidance is forthcoming.

[10]A secondary meaning of "articulated" is a coupling or joining. The articulated QPRT is a qualified personal residence trust coupled with a FLPT which continues for the remaindermen/descendants after the expiration of the QPRT term.

[11]Treas. Reg. § 25.2702-5.

[12]Treas. Reg. § 25.2702-5(b)(2)(ii), (c)(2)(ii).

[13]Prop. Reg. § 26.2632-1(c).

[14]Treas. Reg. § 25.2702-5(c)(5).

[15]*United States v. Estate of Grace*, 395 U.S. 316 (1969). For an excellent discussion of avoiding the reciprocity problem when creating cross secondary spousal life estates in personal residences following the expiration of spousal QPRT terms, *see* Slade, The Evolution of the Reciprocal Trust Doctrine Since *Grace* and Its Application in Current Estate Planning, 17 Tax Management Estates, Gifts and Trusts Journal 71, 75-77 (1992). The grantor spouse's rent-free occupancy as the "guest" of the other spouse should not cause the grantor's spouse a retained interest problem with respect to the portion of the property held in the trust he or she created. See *Estate of Gutchess*, 46 T.C. 554 (1942); Rev. Rul. 70-155, 1970-1 C.B. 189.